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INSTABILITY IN LATIN AMERICA: UNITED STATES POLICY AND THE ROLE OF THE INTERNATIONAL COMMUNITY

HEARING

BEFORE THE

SUBCOMMITTEE ON
INTERNATIONAL TRADE AND FINANCE

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

ON

UNITED STATES POLICY AND THE ROLE OF THE INTERNATIONAL FINANCIAL COMMUNITY CONCERNING ECONOMIC INSTABILITY IN LATIN AMERICA, PROSPECTS FOR ECONOMIC AND PRODUCTIVITY GROWTH, AND THE INTERNATIONAL MONETARY FUND

OCTOBER 16, 2002

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C O N T E N T S

WEDNESDAY, OCTOBER 16, 2002

WITNESSES

INSTABILITY IN LATIN AMERICA: UNITED STATES POLICY AND THE ROLE OF THE INTERNATIONAL COMMUNITY

WEDNESDAY, OCTOBER 16, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON INTERNATIONAL TRADE AND FINANCE,
Washington, DC.

The Subcommittee met at 10:05 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Evan Bayh (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Good morning, everyone. I appreciate your being here on a rainy morning and your interest in this important issue.

I am going to make a brief opening statement and then, Secretary Taylor, we look forward to hearing from you, as we do the other panelists.

First, let me formally call this hearing before the Subcommittee on International Trade and Finance to order.

Chairman Sarbanes will be joining us at some point in the next 45 minutes or so. And I know that the Ranking Member, Senator Hagel, would also want to welcome you and the other panelists. The Secretary has been good enough to be with us before and I welcome you back to the Subcommittee once again.

The Subcommittee is meeting today to hear testimony regarding the instability in Latin America and its relationship to United States policy and the role of the international community.

Our witnesses will include John Taylor, the Under Secretary of the Treasury for International Affairs. As Under Secretary for International Affairs, Mr. Taylor serves as the principal advisor to the Treasury Secretary on international issues, and leads development of policies in the area of international finance and economics. Mr. Taylor will explain the United States' international economic policy and related issues.

Mr. Taylor, thank you again for joining us.

Our second panel includes three very distinguished individuals. Professor Daniel K. Tarullo, Professor of Law at the Georgetown University Law Center. Professor Tarullo teaches in the areas of international economic regulation, international law, and banking law. From 1993 to 1998, he was successively Assistant Secretary of State for Economic and Business Affairs, Deputy Assistant to the

President for Economic Policy, and Assistant to the President for International Economic Policy.

Mr. Tarullo will discuss how the previous Administration successfully addressed the international financial crises of the 1990's, as well as examine what the United States' policy should be in the future.

Mr. Tarullo, thank you for joining us this morning.

Also with us is Dr. Michael Mussa, Senior Fellow, Institute for International Economics.

Prior to joining the IIE, Dr. Mussa served as Economic Counselor and Director of the Department of Research at the International Monetary Fund from 1991 to 2001, a very active decade, where he was responsible for advising the management of the Fund and the Fund's executive board on broad issues of economic policy and for providing analysis of ongoing developments in the world economy.

Dr. Mussa, who is joining us for the second time, will testify about the effectiveness of the International Monetary Fund and the rest of the international community in dealing with Latin American economic instability.

Dr. Mussa, thank you for joining us. He has not arrived yet.

I was reading some very interesting testimony of our witnesses, Mr. Taylor, yours, Mr. Otteman, as well as Mr. Tarullo's, last night. Dr. Mussa actually contained a reference to his family cat in his testimony, which is a first in my experience, but I will explain that later in my questions to the doctor. It was actually amusing and had some relevance to our discussion today.

Finally, Scott Otteman—I hope I am pronouncing that correctly—Scott is with us from the National Association of Manufacturers. Frank Vargo was originally going to be with us, but was otherwise delayed. So, we send him our regards. Scott is the Director of International Trade Policy for the National Association of Manufacturers, which is the largest multi-industry trade association in the United States.

As NAM's Trade Policy Director, Scott is responsible for monitoring and analyzing all U.S. trade negotiations and disputes, including the World Trade Organization and its recently launched Doha Development Agenda, the Free Trade Area of the Americas negotiations, and ongoing talks with Chile and Singapore.

In addition, he works closely with legislative offices on Capitol Hill to advance the top trade priorities of manufacturers, such as the enactment of Presidential Trade Promotion Authority.

Scott will explain the real impact of instability in Latin America on the American business community and to employment and economic growth in this country, and will offer recommendations from the manufacturing sector's point of view about what can be done in Latin America.

Scott, thank you for joining us this morning as well.

A brief statement of my own and then, Mr. Secretary, we will get right to you.

America has a strong interest in global economic stability and growth. At the microeconomic level, more American jobs are dependent upon demand from abroad than ever before.

Scott, I think we will hear some from you in that regard.

At the macro level, a greater percentage of our gross domestic product is derived from exports than at any time in our recent past, and at a time of sluggish domestic growth, foreign markets are more important than ever before.

At the geo-political level, a development abroad is also very important. Democracy and international security are more likely to flourish when economies are stable and prosperity is expanding.

There is currently a debate about how best to advance America's interests. Some argue for intervention to achieve greater stability within distressed nations and to limit the spread of contagion to other nations. Others argue that intervention creates moral hazard and that the unfettered discipline of markets offers the best long-term guarantee of stability.

This hearing will explore several questions related to this debate.

What are the principles that guide U.S. support for economic intervention? Are they solely economic? If so, what are they? Do geo-political factors play a role? If so, how do we prioritize them? Is the political sustainability of the economic policy prescriptions that we offer as a result of intervention considered? If so, how so?

Has the policy of the Administration changed from that originally espoused, to that actually implemented? In this regard, we will pay particular attention to the cases of Turkey, Brazil, Argentina, Uruguay, and Pakistan and compare them to the Argentine experience, once a poster boy for economic reform, now considered by many to be a pariah.

The Committee does this out of the conviction that transparent analysis consistently applied promotes certainty, which in turn limits the likelihood of both contagion and moral hazard resulting from miscalculations by debtors and creditors alike.

Finally, the hearing will explore alternative mechanisms for debt relief, sovereign debt restructuring mechanisms, so-called SDRM's, and also, collective action clauses, so-called CAC's. What would the benefits of these mechanisms be? What are the potential detriments? What are the barriers to their adoption? And finally, are they mutually exclusive, or are they potentially complementary?

To explore all of these questions, we are very grateful for the presence of the Under Secretary, Mr. Taylor. And thank you, you have been very generous with your time to the Committee in the past. So much has happened since you were here last February. I appreciate your coming back with your full agenda. We look forward to hearing from you.

STATEMENT OF JOHN B. TAYLOR UNDER SECRETARY FOR INTERNATIONAL AFFAIRS U.S. DEPARTMENT OF THE TREASURY

Mr. TAYLOR. Thank you very much, Mr. Chairman. And thanks for inviting me to this hearing.

We have written testimony which I would like to put into the record and make some opening remarks.

Senator BAYH. It will be included.

Mr. TAYLOR. Thank you.

Strengthening our ties with Latin America and encouraging economic growth in the region are central to President Bush's overall economic agenda, not only because we want to help our neighbors,

but because we realize that stability and growth in the region is in our interest as well. The United States benefits greatly from strong neighbors and we risk losses when Latin America goes into economic turmoil.

When I testified before this Committee last February, economic and financial conditions throughout much of Latin America were improving, with the exception of Argentina. Growth seemed to be picking up after the slowdown of last year associated with the slowdown throughout the world economy. However, conditions throughout the region have become more difficult since last February. Risks have risen and economic growth this year seems to be coming closer to zero than to positive territory. Clearly, raising economic growth in the region must remain a high priority for the United States and for the countries of the region.

However, considering Latin America as a single entity overlooks some important differences between countries. For example, Chile has very strong economic policies. It is ranked among the most open, competitive, and economically stable countries in Latin America. It grew by nearly 7 percent in the 1990's, well above the average of the region. Similarly, Mexico, after experiencing nearly 70 percent inflation and near-zero growth throughout the 1980's, grew at an average of 5 percent in the late 1990's, and its growth is picking up now, along with the United States.

I would say that El Salvador stands out among those countries that have made tremendous strides by pursuing sound economic policies and emphasizing private-sector growth. Bolivia, Peru, and Colombia are now working to implement a strong policy mix that I believe will enhance stability and raise economic growth.

I would particularly note that President Bolinos in Nicaragua and President Maduro in Honduras are taking very aggressive actions to deal with corruption in their countries, which has been an impediment to economic growth.

As you know, Brazil has experienced significant turbulence relating to election uncertainties in the last few months, despite strong economic policies and efforts to keep inflation low and deal with fiscal policy reform. For Uruguay, events in neighboring Argentina have contributed to significant difficulties, especially this past summer. I believe the Uruguayan authorities, working in cooperation with the United States and the international community, have been able to deal with these problems and there are improvements taking place right now.

Regarding Argentina, which I testified about just last February, I believe that in the last few months, we are beginning to see some stabilization following the significant deterioration in 2000 and 2001, the freeze on the bank deposits, the end of dollar-peso convertability, and the default on its debt. As we speak, Argentina and the IMF are working to conclude an agreement which could create a short-term program to help begin economic growth in the economy by establishing a clear monetary and fiscal framework.

I would also like, Mr. Chairman, to comment briefly on one of the points you made in your opening remarks, and that is the nature of contagion in emerging markets generally.

When you look at the impact of the crisis in Russia in 1998, you see an impact in many, many parts of the world far and unrelated

to Russia, including Latin America and Asia. Interest rate spreads increased at the time of that default in a way that many people commented on referred to the concept of contagion. In contrast, the events that occurred around the world at the time of the crisis in Argentina culminating last December were completely different. In fact, interest rates on sovereign debt showed no such increase as occurred in 1998 in the case of Russia.

I believe this represents a marked change in the nature of contagion between countries.

Just for example, and to be sure, risk spreads did not increase in Asia at that time. They did not increase in Europe. And through much of this year, after the default in Argentina, there was no impact in Latin America as well. Recent events are related to the direct connectedness between Argentina and Uruguay and election uncertainties in Brazil.

So it seems to us that in recent years, investors have become more skilled at differentiating between countries, between good policies and bad policies and focusing on fundamental economic assessments. And that has changed the nature of contagion. We have sought to promote further evolution in this direction by emphasizing that our policy decisions will not be based on unfounded claims of contagion.

Of course, we recognize that there are important direct links between countries, as I have already indicated in the case of Uruguay and Argentina, but I would call that interconnectedness, direct interconnectedness, rather than contagion itself.

So going into the future, what we need to do to raise economic growth in the region and work with the countries is to focus on raising productivity growth. Part of our overall international economic agenda has stressed productivity growth throughout the world, and that stress applies to Latin America with great importance. I am optimistic that productivity growth in Latin America could improve greatly. The truth is that productivity growth was only 0.7 percent in Latin America in the 1990's. It was 1.7 percent in the developed countries in the world more generally and 2.7 percent in the East Asian developing countries. So a 1 or 2 percent gain would make a huge difference in living standards and the reduction in poverty throughout the region.

The first step to raising productivity is to seek to implement appropriate policies that encourage productivity. And here, President Bush has focused on three types of policies that I think are important and apply to any country. The first is ruling justly. That is, to follow the rule of law, concern about enforceable contracts, and to be sure about the importance of corruption and eliminating it and reducing it. The second is to invest in people. That is, to keep the human capital high by strong education and strong health. And the third is to encourage economic freedom. That is, to reduce barriers to trade throughout the world, as well as the informal barriers to trade that exist within countries because of regulations.

There is a long list of policy initiatives that we are engaged in with Latin America. I mentioned some of them in my testimony. The reform of the North American Development Bank, an institution that has not been working well since it was created in 1993, is an initiative that Mexico and the United States have been en-

gaged in for the last year and a half, have made real progress and legislation to carry out those reforms is now in the Congress.

The Partnership for Prosperity intiative with Mexico is something that President Bush and President Fox have instructed the economic officials in both countries to work on, emphasizing private-sector growth.

An effort to work harder to have remittances going from the many immigrants in the United States back home to countries in Latin America to make it cheaper is another initiative. Relative to the size of the economies, especially in Central America, there is a huge amount of money that is sent home from immigrants to their families. I was in an elementary school in El Salvador this summer and asked the children in the class how many had relatives in the United States, and it was virtually 95 percent. And in El Salvador, approximately 25 to 30 percent of their income is in the form of remittances from the United States.

We can help these countries prosper more if we make it easier for immigrants to remit funds back to these countries.

As you know, we are pursuing a free trade agreement with Chile right now. We hope to conclude that as soon as possible, now that the Trade Promotion Authority has been passed. The President has notified the Congress about initiating talks on a free trade agreement with Central American countries, and we are pursuing a free trade agreement with the Americas as a whole.

We are supporting the Inter-American Development Bank, the World Bank, and the IMF to be of assistance, focusing on good policies. As I indicated, the President has delineated and focusing on measurable results to make sure that the funds are used effectively. Our negotiations with the World Bank's IDA program, in the past, replenishment has forged new ways to make these funds more effective through grants and through an insistence on measurable results.

So, in conclusion, Mr. Chairman, I think that in spite of the recent turbulence in some countries in Latin America, that the region has enormous potential and that we can look forward, with the right policies, to better economic prospects in the region in the future.

Thank you, Mr. Chairman.

Senator BAYH. Thank you, Mr. Secretary.

I am grateful for your time. Let me say at the beginning, I admire your optimism, and I understand the importance not to gratuitously undermine confidence.

I am reminded of someone in a much different context who came to visit me the other day and gave me a definition of a pessimist I had not head before. He said: "A pessimist is an optimist who has access to better information."

[Laughter.]

There is some information out there that would suggest that it may be a difficult road, but I understand the importance to look at the glass as being half full and to do what we can to buttress confidence and take your comments in that light.

Let me begin by asking you something, Mr. Secretary, in your prepared testimony, about the size of interventions that the IMF has conducted and that we have supported. I am sure you are

aware—the President made statements back during the campaign that we would not be supporting the kind of large interventions we had in the past. The Secretary made some comments to that effect in his testimony at his confirmation hearings. There have been other statements. You are familiar with this.

And then in your testimony today, you say, "We are working to increase discipline in terms of access to IMF resources that will reduce the size of IMF packages . . ." in order to ". . . reduce the risk of moral hazard."

That has been pretty much a consistent explanation of the policy throughout. Let me list some of the interventions that have taken place and just ask for your reaction.

With regard to Brazil, I think there was a $15 billion IMF program for Brazil equal to roughly four times the normal annual IMF access limit committed in September 2001.

With regard to Turkey, a further $12 billion increase in IMF support was committed to Turkey in February 2002, raising the total support to $31 billion, a record for the IMF up to that time in absolute amount, in support relative to IMF quota, and as a share of the country's GDP.

With regard to Uruguay, given their size, a relatively large $1½ billion augmentation of the IMF support in June 2002, and a further increase in official support, raising total committed support to $3.8 billion in August 2002, setting a new record for the ratio of official support to GDP.

And finally, the $30 billion augmentation of IMF support for Brazil committed in September of this year, just a couple of months ago, setting a new all-time record for the absolute level of IMF support committed to a single country.

Given our desire to try and reduce the size of these interventions, how do we explain the series of relatively large interventions that we have, in fact, supported over the last couple of years?

And again, I say this not to be critical. I am just trying to explore perhaps—there is either a disconnect between our stated policy and our actual implemented policy, or perhaps there has been an evolution in policy to take into account changed circumstances.

Can you react to the list of interventions in light of the policy pronouncements?

Mr. TAYLOR. Of course. Thank you very much for the question.

I do not believe that there has been a change in our policy with respect to where we intend to go, which is to try to address some problems that existed in the emerging markets and still exist. And those problems are that the flows of capital to the markets diminished greatly in the late-1990's. The flow of capital from 1992 to 1997, on the private side, based on net calculations, was over $150 billion a year in that period.

In 1998, 1999, and 2000, the flows dropped to less than $50 billion. Some people refer to that as a sudden stop. There were quite a few crises that occurred in many countries around the world in the mid- to late-1990's. And interest rate spreads remain still very high and it is a burden on the taxpayers in these countries.

So these are the kinds of problems that we want to address with our emerging market policy. And part of that is, as you say, Mr. Chairman, to reduce the size of packages and to make the packages

more interpretable, clearer to the private sector, to the official sector and to the countries themselves.

Two of the countries that you mentioned—Turkey and Argentina—were in crisis as we started in the Administration. And we worked hard to improve the situation. I believe Turkey, with the proposals that we put through, the prior conditions that Turkey was in, has greatly improved. Inflation is down and economic growth is up.

The program that we dealt with when Uruguay was, I think, a classic focus on significant monetary issues, exactly the issues that the IMF was designed to handle. Uruguayan authorities had good policies in place. They were hit hard by the shock in Argentina.

We developed a surgical, I would put it, well-focused plan to deal with the problem in their banking sector. The size of that program was because it focused on keeping the payment system going, and I think it was very effective.

Now with respect to the overall size questions that you mentioned, one of the important principles that we have tried to follow and indicated at the beginning was that in order to begin reducing the size of packages and to make the size clearer to people in the market, we wanted to have the focus be on the IMF, on the international financial institutions, rather than provide additional support and additional access from bilateral contributors such as the United States, the G7, and the G10.

The case of Turkey was the first place that we established this principle. And that program did not have large bilateral, large-scale, medium-term support from the developed countries. That is, in fact, why the program was a little larger from the IMF. The overall program was smaller.

Similarly, in Brazil, the program that was just put through the IMF, it was smaller than the program in 1998, which was approximately $42 billion. As you mentioned, this program was $30 billion.

The reason is that the bilateral side of this program was not there as it was earlier. The additional contributions from countries around the world, which has the same notion and the same concept of funds was not there, so the overall program was smaller.

And with respect to Uruguay, the only kind of bilateral support that was there was a short-term bridge loan from the United States which was very important to get those banks open as soon as possible.

I believe if you look at this general strategy, we are adhering to it. We are focusing on the IMF, which has, after all, a limited overall supply of resources. That puts a budget constraint on their operations. It puts accountability where it belongs, on the people who are working closely on the programs. We think it is working.

The last thing that I would say about this, Senator, is I think the strategy that we are taking is one that has to be implemented gradually. We would like to reduce the problems that I mentioned at the beginning. It does require changes in policy. But to change that overnight, to suddenly say there is going to be a stop of funds without any notification, I think can be disruptive.

As an example of that, let me just finish with this problem that has arisen in Argentina. Argentina had a crisis in the fall of 2000, an IMF program. When we came in, they were off that program.

So, we said, rather than make a sudden change, let us give a waiver in the spring of 2001.

In the summer of 2001, they were beginning to run into difficulties because of a bank run, people pulling money out of the banks. As a result, we decided in that context that an augmentation of the program would be clear, but with a clear emphasis that the debt was beginning to be a problem and needed to be addressed and we focused the nature of our program on that.

Then, finally, in December of last year, after a lot of indications of what we would do when the situation became clearly unsustainable, and when the program was off track, we supported the IMF decision to stop the support to Argentina because the policies at that point in time did not merit it.

It seems to me that that is very consistent with the strategy that we would like to take, and that is to support countries that are doing the good things and have the good policies, but to hold back in unsustainable situations and hold back in situations where the countries are not following good policies. And we are trying to adhere to that as closely as we can.

Senator BAYH. Well, let us use that as an example, Mr. Taylor. You have outlined here a fairly pragmatic approach with regard to Argentina. You intervene when it seems that there is some hope for accomplishing some good, and you do not when it clearly would just be throwing good money after bad. That seems to be a sensible approach to things.

I would like your reaction to—and I say this not to be critical, but just as an observation that there has been an evolution in a more sensible direction. But it is my observation that perhaps we have made a shift from an ideologically based policy to a more pragmatic policy. You mentioned the change in capital flows was one of the reasons that we supported some of these interventions.

It would seem to me that our policy might be described as, we would prefer not to support these large interventions, but if the circumstances justify it, we will do so. Is that a fair commentary?

Mr. TAYLOR. I hope that we would be pragmatic in policy decisions and maintaining a set of principles, such as the one I indicated, trying to limit access, just trying to be more predictable.

By the way, trying to deal with this restructuring issue, which you want to come back to, on the sovereign debt side. Trying to deal with crisis prevention. Adhere to those principles. But there is no but about it. In practice, decisions come to us and we have to do the right thing at that time.

I believe that what we have done here is be guided by these principles. We are always going to be pragmatic. These are very important issues. They affect many people's lives. And I believe that the strategy of gradually moving in a direction to address the problems that exist is the right approach to take.

I believe it has always been pragmatic, Senator.

Senator BAYH. Thank you, Mr. Secretary. Let me ask about a couple of specific instances, one I believe that you just addressed. The first is the $8 billion augmentation for Argentina in August 2001. Everything in hindsight appears to be clear. With the benefit of hindsight, was the decision to support augmentation a mistake?

Mr. TAYLOR. I do not believe so, Senator, no, it was not.

Senator BAYH. Do you think the money will ever be repaid?

Mr. TAYLOR. I certainly expect the money to be repaid.

The decisions at that time, as I indicated, had to do with Argentina in a crisis, had been in a crisis for several years. And what we would like to do at that point is ultimately get them back on a strong path, with strong economic growth, help the people of the country and the region.

And to do that, we thought at that point in time, the augmentation was appropriate. Of that augmentation $3 billion, by the way, was dedicated to trying to move ahead on the debt, a debt swap. Five billion dollars was dedicated directly to the bank problem that they had in time. So, I think it was designed in an appropriate way.

I would also say, Senator, in terms of moving gradually toward a policy of limiting access, this seemed to me important to do. After all, there was very little contagion from Argentina at that time. Moving gradually I think was part of that.

When the event actually took place last December, when the IMF stopped support, it did not have the impact that the Russian default had in 1998. There was, as I said in my opening remarks, very little ripple effect, not even in other parts of the world, but not much in Latin America at the time, either. Uruguay was right next door and we dealt with that problem.

I think if you look at the policy and you see the impacts, it was important to move gradually in the decision of last December, of last August, as well as the decision to have a waiver in April 2001, I think was correct.

I sincerely wish that Argentina did not have to go through the problems they went through this year. That is a tragedy. But in terms of signaling our behavior and our changes, I think we did the right thing.

Senator BAYH. Thank you. Let me return to that for just one moment. And the reason I do so is not to play gotcha, or say, well, it was a mistake, although I must say that, I guess from my vantage point, I can afford to be a little more pessimistic about the outcome of these things than can you. But the reason I return to it is for the benefit of decisions going forward in an attempt to learn from that decision, if perhaps it has not turned out quite as we had hoped, and what can that do to inform us about making future decisions when confronted with circumstances somewhat similar to those—we hope there won't be too many similar to those—but future sets of circumstances.

What have we learned from the Argentine experience? Where did we go wrong? Why did they deteriorate so dramatically? What did we not know at the time the augmentation was made that we know now, and how can we apply that to future circumstances?

Mr. TAYLOR. Argentina made some very important reforms in the early 1990's—controlling spending, on the tax side and on the convertability side, got the inflation down by huge amounts, and the economy grew very successfully in the early-1990's through the mid-1990's.

About that time, Argentina started to move back on those policies, on the spending side, on the tax side, and ultimately, began to raise questions about their convertability law.

And when those actions began to take place, the economy started to deteriorate. There were shocks from abroad, to be sure, as all countries are subject to, but the policies were not conducive to economic growth and economic growth faltered.

I would say that that is, to me, the main lesson of Argentina, is that countries——

Senator BAYH. It happened so precipitously after our decision in August 2001. What didn't we know? Was there just not transparency of information coming out of Argentina? We augmented and then, pretty quickly, they headed downhill.

Mr. TAYLOR. No, I would not characterize it that way at all. What happened is, in the period of 1998, 2000, 2001, growth was getting slower, problems were arising. There were two or three periods where sovereign debt spreads increased by quite a bit. The debt was growing, raising questions about sustainability.

We tried to work with them, as we are continuing to work with the economic officials in the country to help them with the policies. We gave them the support. I do not think that it was a mistake to do that support last August, and I think it was effective in the sense of keeping the contagion down throughout the region and throughout the world.

It was an assistance there. And that is one of the things that I think we would like to try to do, is when there is a damage effect, such as in the case of Uruguay, try to deal with that contagion, which we did.

But we do not really see, as I see, the contagion effects that existed in the past and I think the policies are one reason for that.

To me, the lesson that I would stress most of all is, when a country has demonstrable problems with the sustainability of its debt, and where it chooses to address those problems by restructuring, there should be a more orderly way for the country to do so. And that is one of the reasons why we are pursuing some reforms of this sovereign debt restructuring process. And you mentioned two approaches that are out there.

I think that if we can make those changes, it will be easier to adhere to the access limits that we would like to adhere to, because there will be a route for countries to take if they get into this very unfortunate situation of sustainability.

I believe countries should not get to that state. It is a mistake for countries to get to that state. They should take every effort they can not to get into the state of unsustainability. But when it happens, we have to find a way to make it more orderly. And that is really the main lesson, I think, from these recent crises.

In 1996, the international community suggested collective action clauses. If we had started in 1996 on introducing collective action clauses into these debt instruments, the world would be completely changed. The emerging market debt would have changed, and I think in a very constructive way.

What we are trying to do now is let us get back to this. It is at the top of our agenda. Let us get the collective action clauses working with the private sector and the emerging markets themselves into these debts, so when these very unfortunate events happen, it is a smoother, a more orderly process.

Senator BAYH. As you know, that is on our agenda today as well, and I do think that this debate about where we go forward is an important part of this process, just as we attempt to learn from past decisions.

However, if I could just offer an unsolicited opinion about one of the other lessons that we learned, and that is why I alluded to it in my comments.

The implementation of sound economic policies and the political sustainability of those actions in the country in question, it seems to me, are inextricable. And perhaps we did not have as great an understanding of the internal political dynamic and problems in Argentina that we now have, and their ability to really make the hard decisions and to not just talk about them and propose them, but really implement them, not only at the Federal, but also at the provincial level, is something that I think we know a lot more about now than we did then.

So perhaps a focus on some greater political analysis, combined with economic analysis, is something that we could benefit from going forward. Is that a fair observation?

Mr. TAYLOR. I agree with that. We can improve our economic analysis, but we also can improve our political analysis.

I would say, though, and this is something that President Bush has emphasized, that the ownership of the policies by the countries really should be their responsibility.

It is so important for whatever policy is taken, that it be owned by the country, that in a democracy, the people have chosen that policy, rather than have it be imposed from the outside, whether from the United States, the IMF, or whatever organization.

And President Bush has emphasized this ownership and accountability on the part of countries. We are working toward that. I believe the Millennium Challenge Account emphasis on good policies in the countries and aid will go to the countries that are following good policies, and it will not go to countries for economic development if they are not following the good policies.

It is a new approach which I am excited about. It goes in the direction of making the policies that will cause growth more likely, and I think that there is still tremendous evidence that countries like Chile, who are following good policies, are succeeding, and countries which have chosen, unfortunately, poorer policies, like Argentina in the late 1990's, are not succeeding.

And that is the lesson and we need to encourage that. But the countries themselves have to make the decisions. It is their political system. It is their country. And we just want to emphasize that as much as we can.

Senator BAYH. Thank you, Mr. Secretary.

I mentioned there were two examples. We touched upon the Argentine one. I would now like to ask you about Brazil. And again, it is in the context of—welcome, Chairman Sarbanes.

We are joined by the Chairman of the Banking Committee, Senator Sarbanes.

Thank you, Paul. I would be happy to interrupt my questioning here.

Senator SARBANES. No, no. Thank you.

Senator BAYH. I would touch briefly upon the topic of Brazil. And the point I wanted to make, which I alluded to in my opening comments again, is the importance of transparent policy consistently applied, it seems to me leads to better outcomes in the long run.

If we were making statements about discouraging people from an expectation that there were going to be significant interventions because of our preference not to do so, that is a consistent point of view. Favoring interventions is also a consistent point of view. When we waffle around in the middle, we can run into some difficulties. I would just like to mention Brazil as an example. And I say this not to criticize the Secretary, but I will just get right to the point.

We were discouraging the belief that there would be significant interventions. Comments, perhaps offhandedly, later softened, were made that had the effect of perhaps undermining confidence in Brazil, which then we decide that we need to intervene, and because of lower confidence, the size of the intervention is greater, or the cost is greater than it would have been otherwise. So do you want to comment upon the case in Brazil and some of the comments that were made, the effect on confidence? I think the ultimate package, although you mentioned the absence of bilateral assistance, at least at the time, it struck observers as being about twice the size that the market had been expecting. I am kind of wondering if that was in some ways related to the damaged confidence in the markets that existed at that time.

Mr. TAYLOR. No, the size of the package and the profile was something that the Brazilian officials had been discussing and had thought about with the IMF.

In fact, the profile is important to mention. The lion's share of the funds would be disbursed after the new administration begins in office in this program. And that was one of the ideas that the Brazilians focused on, that if the different candidates in the election could agree to a certain common denominator with respect to a sound fiscal policy, and agree to continue that after the election, then the funds would continue to be distributed. So the size and the timing were based on the circumstances in Brazil.

I would also say, Senator, you mentioned this in your introductory remarks, but Brazil also came to the international community in the summer of 2001, when Argentina was undergoing the crisis that we just talked about.

Their IMF program from 1998, which I said was $42 billion, including the augmentation from other sources, was coming to an end at the end of last year. And they asked for a new program, considerably smaller than the old one, but it made sense at the time.

Senator BAYH. I guess my question goes to our own policy and the consistency of our approach.

Mr. TAYLOR. Okay.

Senator BAYH. Which, as I said, we seem to be evolving to the right direction.

Let me just read you the quote, and again, I say this not to be personally critical of the Treasury Secretary. This is at the time Brazil is very much in play in the markets: "Throwing U.S. taxpayers' money at the political uncertainty in Brazil doesn't seem brilliant to me."

That is a direct quote from the Secretary. And you can imagine how the markets received this. When we turn around and do exactly that, when we describe it as not a brilliant idea, perhaps that has some effect on the kind of steps that we have to take.

Mr. TAYLOR. Well, I think the Secretary's comments, I do not know the context of those, exactly. There was clearly a lot of discussion about the uncertainty relating to the election.

As I say, right at that point in time, we had had an augmentation of a new program from Brazil, so people interpreted that in that context. It may not come to the conclusions or raise the questions that you are raising.

I believe that we should be as clear as possible to the markets about what our intentions are. You cannot lay out every decision and every contingency into the future. But you can try to be clear.

I think that is what we are trying to do. I mentioned moving gradually to a new type of policy, trying to reduce the number of crisis countries. When something comes up like Uruguay, let us be clear why we are doing that. It is because they are so close to Argentina and we can narrow in and help them in this particular case, and come as close to the principles as we can.

I hope I am answering your question satisfactorily, Senator.

Senator BAYH. You are doing an admirable job, Mr. Taylor, under somewhat difficult circumstances.

I guess I would sum up and ask the Chairman if, at this point, he would like to comment. But as I said, it seems to me that it is a logical approach to try and limit interventions, or it is a logical approach to favor interventions.

We seem to now be gravitating toward a pragmatic third approach, which there are also underpinnings for if we set objective criteria transparently for meeting interventions.

My point is that when we seem to swing from one to the other in the context of a particular intervention, there are costs to that, if you undermine confidence and you have what might appear to some to be an inconsistent application of policy. That is the only point I am trying to make. We should arrive at an approach, stick with it consistently. And it seems to me that that is the best way to move forward.

Mr. TAYLOR. I agree with that. We will try to continue to work to be clear about what the principles are, what the problems are we are trying to solve, and adhering to those as best we can in the real-world environment that we face.

Senator BAYH. Thank you, Mr. Secretary.

Chairman Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Senator Bayh.

First of all, I want to commend Senator Bayh, who chairs our International Trade and Finance Subcommittee, for holding today's hearing.

Oversight of the conduct of international economic policy is a vital function and significant priority of this Committee. In fact, earlier this year, Senator Bayh chaired an oversight hearing with Secretary Taylor, as a matter of fact, on the economic problems confronting Argentina. Earlier, I had chaired a hearing of the Full

Committee with Secretary O'Neill on the Treasury Department's Report to Congress on International Economic and Exchange Rate Policy. This morning's hearing carries on that oversight effort.

I think it is fair to say that the United States has a very large stake in economic and political stability in Latin America.

Further, the response by the United States and the international financial institutions to the problems of Latin America has significant implications, I believe, for the conduct of policy elsewhere in the world.

In that regard, I have considerable concern over the way the Administration has responded to the problems in Latin America. That point is made rather forcefully by some of the witnesses who will come on the second panel.

In fact, I am going to depart from usual protocol because I have not figured out an answer to this yet myself.

As a matter of tradition, we put the Administration's witness on first. Then we hear from the panel, which usually is a balanced panel. But we get, on occasion, some sharp criticisms of the Administration's policy. Of course, by that time, the Administration's witness has testified, answered questions, and left. So the panelists are coming, as it were, after the fact. And we never get the two meeting.

What I am going to do this morning is quote from some of what the panelists will tell us subsequent to the Secretary's departure and ask the Secretary to respond to that.

Michael Mussa, who is the Senior Fellow at the Institute for International Economics, and was formerly the Economic Counselor and Director of the Department of Research at the IMF, says in his oral statement here to the Subcommittee this morning:

> I see a fundamental inconsistency between the U.S. Administration's rhetorical opposition to large-scale assistance packages to aid in emerging market financial crises and the actual practice of supporting a remarkable number of such packages.
>
> Indeed, despite its continuing rhetorical opposition, I count at least six occasions when the Administration has endorsed large-scale assistance packages during the past 20 months.
>
> I believe that the glaring inconsistency between these facts and the Administration's rhetoric has done significant damage. Other countries have been confused and in some cases, offended, by the confusion in U.S. policy.
>
> In particular, officials in Brazil and in much of Latin America took umbrage at Secretary O'Neill's remarks last summer, suggesting that further official support for Brazil would be a waste of money that would be opposed by the U.S. Government, a policy statement that was soon disowned and then reversed.
>
> For the international community to play a constructive role in the resolution of emerging market financial crises, it needs to behave in an understandable and reasonably predictable manner. Otherwise, other key actors will not be able to function in a sensible manner.
>
> Constructive leadership from the United States is essential in defining the responsible role that is to be played by the official community. Recently, such leadership has been lacking.

What is your response to that?

Mr. TAYLOR. Senator, when you look at the decisions that we have made since the start of the Administration, I believe they are consistent with a set of principles that we have been trying to adhere to. Those principles are designed to deal with some real problems that have existed in the emerging markets since the mid- to late-1990's. The first of them is the significant drop of private capital flows to the markets. The second is a large number of crises

that came in the 1990's compared to the 1980's and earlier periods. And third is continuing high interest rates on debt that emerging market countries have to pay.

Our strategy is designed to deal with those by working at better crisis prevention, at trying to deal with the reform of the debt restructuring process, at being clearer and more predictable about access, and I will come back to that in a minute. And that strategy is something that we have articulated in testimony and in speeches. It is one that we make clear to the markets when we talk to people in the markets and to countries when they talk to us. In particular, many countries in Latin America.

Why might one think that there are inconsistencies? One possibility is part of our endeavor to reduce and make the access policy clear is to focus more attention on the IMF and make the IMF accountable for the decisions.

We are doing that by saying, whenever we can, we would like to have significant, large-scale, medium-term support from the bilateral community, from the United States, from the G7, not part of these packages. That basically puts more focus on the IMF.

Now, as a result of that, the IMF part of the package could be larger. But the overall package will be smaller. And so, I would just give you the examples of this.

The 1998 package for Brazil was $42 billion. The package that you are raising now as an inconsistency, quoting Dr. Mussa, was $30 billion.

For what it is worth, and I think the size of the recent one is appropriate and the timing is appropriate, it is smaller.

The case of Turkey, there were requests for the United States to go along to augment the IMF's contributions. We thought it was important not to do that, in the effort of being more predictable.

What is the market to expect where sometimes the official sector beyond the IMF is in and sometimes they are not? If they realize it is the IMF, then it is an effort to be more predictable.

So it was the IMF and the international financial institutions in the case of Turkey.

Senator SARBANES. Let us take the Brazil example.

Mr. TAYLOR. I think there is a consistency, Senator.

Senator SARBANES. Well, I am having a hard time finding it. Let us take the Brazil example.

On June 21, shortly after Brazil's government tapped a $10 billion line of credit with the IMF, Secretary O'Neill suggested that the Bush Administration would block additional IMF loans to Brazil saying, and I think that Senator Bayh quoted this before: "Throwing the U.S. taxpayers' money at a political uncertainty in Brazil doesn't seem brilliant to me."

He added, "The situation there is driven by politics. It is not driven by economic conditions."

This is in *The Wall Street Journal,* June 24.

Later that same day, Secretary O'Neill issued a statement clarifying his remarks, in which he asserted that: "The Brazilian government is implementing the right economic policies to address the current difficulties."

Now, what is the policy thread that runs through that? I am having a hard time finding it.

Mr. TAYLOR. These are, I take it, quotes from the same day you are referring to? I believe they are from the same day.

Senator SARBANES. Yes.

Mr. TAYLOR. It seems to me, Senator, when you take a quote out of context, you know very well that you run the danger of misinterpreting. And it is important, as Secretary O'Neill did on that day, to provide the context for his earlier quote, and he did that, and I think the context made it clear that, just as I said before, our policy is to support countries who are following good economic policies to create strong private-sector productivity growth. And the message from the quotes that you mentioned is that.

Senator SARBANES. You think I have taken them out of context?

Mr. TAYLOR. Senator, I do not know if you have——

Senator SARBANES. Did the Brazilian government take them out of context in terms of its very strong reaction, reaction so strong—let me read you the statement that the Secretary put out on June 21. "To clarify my earlier comments, the Brazilian government is implementing the right economic policies to address the current difficulties."

This is after he has said that throwing U.S. taxpayers' money to political uncertainty in Brazil doesn't seem brilliant to me.

Because of these policies, we have consistently supported Brazil, including through its current IMF program, launched last summer, and last week's $10 billion drawing on that program. Brazil has not requested new funds and its economic fundamentals are strong.

Brazil is a critical regional and global partner of the United States. It seems to me that the Secretary is backtracking pretty fast in that statement.

Mr. TAYLOR. The policy, as articulated by the Secretary and the Administration is to support countries with good policies.

Senator BAYH. Mr. Taylor, forgive me for interrupting. I was just pointing out to the Chairman, most importantly, the markets reacted adversely to those comments. So, they were looking at it in the context of the overall statement and apparently they reached the conclusion that something was amiss.

Mr. TAYLOR. This is a question about the market reaction to particular statements by Secretary O'Neill?

Senator BAYH. No, just that the markets reacted to the comment that it was not a brilliant idea to engage in the intervention and then the clarification had to be issued to help calm the impression that the markets had reached.

Senator SARBANES. Well, I take it that you are telling me that this was all part of a thought-out strategy. In other words, it was part of a thought-out program that the Secretary should make these remarks, that you should get the kind of reaction that you got from Brazil, and then the Secretary should issue his clarifying statement. That was all thought out, that was part of the program?

Mr. TAYLOR. I did not say that, Senator.

Senator SARBANES. Oh, okay. What are you saying?

Mr. TAYLOR. I am saying that we have a policy with respect to our economic support and it is to support countries that are following good economic policies. We have been clear about that. The Secretary has been clear about that. The President has been clear about that.

Senator SARBANES. Well, you say that you are not going to do these big programs and then you do them every time. I do not understand what is happening.

Let me carry the Brazil thing a step further.

In July, Secretary O'Neill told *Fox News Sunday* that aid will be forthcoming only after Latin American nations can assure that the aid: "Doesn't just go out of the country to Swiss bank accounts, upsetting financial markets and setting off a diplomatic tiff with Brazil."

And in another turn-around, on August 1, the Secretary released a statement saying: "I continue to favor support for Brazil and other nations that take appropriate policy steps to build sound, sustainable, and growing economies."

Just 1 week later, the IMF announced the $30 billion loan for Brazil. The Treasury Department was quick to issue a statement to express its support and even its pleasure at the announcement.

Which obviously leads to the question, in light of all these contradicting statements, what was the strategy with regard to Brazil?

Mr. TAYLOR. The strategy is the same as our strategy for any country. And that is to support countries who are following good economic policies, to stress the ownership of those policies.

Brazil, under the leadership of the Central Bank President, Arminio Fraga, has instituted a good program to get inflation down from the horrible hyper-inflation levels that Brazil experienced. They have adopted a fiscal responsibility law to deal with the provinces. The President has instituted great improvements in the social sectors in the economy. So it is a good set of policies and we are supportive of that.

The question about consistency it seems to me is answered by looking at what we have done with respect to countries, the overall strategy that we have put forth in testimony, in speeches, where it is all laid out. And I think if you spend all the time taking excerpts from remarks, that that is not the way to look and evaluate a policy.

Senator SARBANES. Mr. Secretary, I am not taking excerpts from remarks, in the sense that these were remarks that were made that created a major reaction. The reaction was so strong, that it then led the Secretary to issue "clarifying statements." There was tremendous confusion about what the Administration's policy was, and is. And I think that is a problem.

Now you can sit at the table and say, well, you are just picking a quote—and if there had been no reaction to it, if there had been no consequences flowing from that, that would be a reasonable point for you to make—why are you pulling this little quote out and using it? But I am focusing on the quote because it created major reaction.

Let me quote you what Dan Tarullo, who is also on the next panel, says in his statement.

And I apologize, Mr. Chairman.

Senator BAYH. No, no. Please continue, Chairman Sarbanes.

My comment, Mr. Secretary, was, I understand you have to defend the Secretary. My comment was that I think it is incorrect to in any way imply that the Chairman was taking quotes out of con-

text because the market had an adverse reaction to the totality of the comments.

Senator SARBANES. Let me just quote Tarullo.

"The voice of a U.S. economic official is itself an important instrument of policy. A consistent, measured, and coherent voice establishes credibility, reassures market actors, and enhances U.S. economic leadership. The absence of such a voice has just the opposite set of consequences. While I think it unfair to hold the Administration responsible for all the financial problems faced by emerging markets . . ."—and I would insert, I would certainly agree with that—". . . I think it legitimate to criticize the lack of consistency, coherence, and restraint in its statements and actions."

Now, I think that is right on point.

Mr. TAYLOR. Well, Senator, I do not think it is, and if I could respond, if this is a question that I could respond to.

Senator SARBANES. Sure.

Mr. TAYLOR. Throughout this period that you are referring to in Brazil, part of my job is to be in close contact with the economic officials in the other countries with, for example, Arminio Fraga.

Secretary O'Neill is equally in close contact with the officials in those countries. He made a trip to the region at roughly the same time that you are referring to these quotes.

He has a great deal of knowledge of Brazil and supports the Brazilian people, has friends there, business contacts, over many years. Our relationship with the Brazilian economic officials is good and continuous. And the same with the markets.

Markets move for many reasons. And I believe that what we have been trying to do and what the Secretary has been trying to do effectively is to maintain the contacts with the people in the markets, with the officials in Brazil. It is a very good relationship and as I have tried to indicate, there has been a great deal of consistency with how we have approached it.

With that, again, you can refer to quotes and I can continue to respond. But I think if you put this in the broader context of all the testimony that the Secretary has done, all the speeches that he has given, I have given, and others have given in the Administration supporting the overall policy of the President on emerging markets and developing countries, trying to improve the lives of the people around the world, trying to focus on water for people who do not have enough water, the whole ramification, the whole spectrum of policies is dedicated to improving—and if you look at the whole context, I think you are going to see a very impressive change in policy on the development side and the emerging market side that is already beginning to have effects. So put it in the overall context, Senator. I would ask you to do that.

Senator SARBANES. Are you suggesting to me that the Brazilian authorities welcomed these quotes from the Secretary that I read?

Mr. TAYLOR. You will have to ask the Brazilians what they thought about that. I know we have had good contacts with the Brazilians. The Secretary has good relationships.

Senator SARBANES. If they did welcome them, why did they react the way they did, forcing you all to make a clarifying statement? And also, then, to come along with these other statements about what a wonderful partner they have been and the importance of

the economy, and so forth, all of which I agree with. But why was that necessary if they did not welcome them?

Mr. TAYLOR. Well, because it is the whole context. If there is a particular statement that is made and it is quoted, let us give it the context. I think anyone would like to say, if there is one sentence that is pulled out of remarks and that is getting attention, let us give it the whole context that it belongs in.

Your assumptions about the reasons for the changes I cannot agree to. But I can say that the effort is to put the whole thing in context. And I think the whole context is good and effective.

I support what the Secretary is doing.

Senator SARBANES. Mr. Chairman, I would just close with this. I want to quote Tarullo again. You will have him on the next panel.

"The voice of a U.S. economic official is itself an important instrument of policy. A consistent, measured, and coherent voice establishes credibility, reassures market actors, and enhances U.S. economic leadership. The absence of such a voice has just the opposite set of consequences."

Thank you for doing this hearing.

Senator BAYH. Thank you, Chairman Sarbanes, for your time.

We are very grateful to you, and for the Full Committee's support of our hearing.

Thank you.

Mr. Taylor, I have a few more questions. I know we have kept you a while.

Let me return to the topic of contagion. You have suggested once again that the market is getting better at evaluating risks and so forth, and that what we have traditionally considered to be contagion is not as great a risk as it used to be. And in the case of Uruguay, I think you used the term, direct interconnectedness. How would you differentiate between direct interconnectedness and what we would traditionally consider to be contagion?

Mr. TAYLOR. The former is where there is a trade flow or a financial connection. Tourism, for example. Montevideo is just across the river from Buenos Aires.

Senator BAYH. So it is physical proximity?

Mr. TAYLOR. That is one way to measure it. Frequently, there is more trade between countries that are close to each other. Not all the time, but it is frequently a way.

But the other would be where there is no real connection. Let us take Brazil and the Philippines, for example. Or take Russia and Argentina. In 1998, when Russia defaulted, there was an impact in Argentina. But there is very little direct connection in terms of trade flows between the countries, say, compared to Argentina and Uruguay. In 1998, there was an impact, a visible impact on the spreads on interest rates in Argentina after that default in Russia.

Senator BAYH. Are interest rate spreads the only thing you look at to determine whether there has been a contagion effect?

Mr. TAYLOR. No, but that is the one that has been given the most attention in the markets. It is the one that people refer to mostly in the financial crisis earlier. No, there is clearly other things to look at.

Senator BAYH. Let me read a couple of quotes and get your reaction to this. You are aware that there is another school of opinion on whether contagion continues to be a potential problem or not.

This is a story from *The Wall Street Journal* on Monday of this week. It is entitled, "Guilt By Association—U.S. Officials Insist Financial Contagion Is Over. Period. Not So Fast." That is the headline. And let me read you a couple of quotes and get your counter-argument here with regard to Argentina.

"But with Argentina in default on most of its government debt, investors also focused on whether Brazil could sustain payments on its own debt regardless of the outcome of the balloting, suggesting that there was more than just political risk there at play."

This is a quote—" 'Seeing Argentina, nobody wanted to take chances and give Brazil the benefit of the doubt,' says Walter Milano, head of Emerging Markets Research at BCP Securities, Inc., a brokerage firm in Greenwich, Connecticut."

That sounds like classic contagion to me, with everyone at the risk premium rising, not because of political factors, but just because of a generalized fear spawned in Argentina that Brazil might also have been in trouble.

The second quote is, and this deals with the spread of political risk. " 'People are much more concerned about making long-term investments and they are reviewing contracts backward and forwards,' says David Gould, Director of Global Economic Analysis for the Institute of International Finance."

"There is a sense among international investors . . .," he says, that once a country opens its markets, ". . . it doesn't mean they are open forever."

You know what is going on in Argentina with the bankruptcy laws and the abrogation of contracts and that kind of thing.

What do you say about these comments? It sounds as if at least some people are perceiving the existence of good old-fashioned contagion out there.

Mr. TAYLOR. I found that the stance that we took early in the Administration that contagion had changed got quite a bit of criticism when the Secretary made it and when I made it.

But the things we referred to were the spreads, and that was the measure. And in fact, we turned out to be quite correct, as I have indicated with respect to comparison of Russia and Argentina.

But I have also noted that people have sometimes developed new interpretations of contagion or perhaps referred to old ones. I really do not think it makes a difference.

One of them is this political contagion idea. And the idea is that perhaps countries see the politics or policy changes in one country, or investors see those changes, and worry that another country is going to take those same policy stances, same policy changes. I do not see a lot of that, to be honest, because I see the message from poor policies such as——

Senator BAYH. I am sorry, Mr. Secretary. You do not see a lot of what?

Mr. TAYLOR. I do not see a lot of the so-called political contagion.

Senator BAYH. What is going on in Brazil?

Mr. TAYLOR. There was a lot of concern that the halting of a privatization in Peru was due to political contagion, that people said,

we do not want that privatization because we see what is happening in Argentina.

It was completely wrong. It was a local issue. The people in the community wanted to be involved in the privatization. They indicated their views. The government has changed. It had nothing to do with political contagion. It did not exist.

The other thing is, this is speculation. You said that we should improve our political analysis. That is probably right.

But what would be the message that a country would get from what Argentina has done in the last year, changing the bankruptcy law in a negative way. It is fortunately fixed now.

It would be negative. These were leading to bad, have led to bad results. And I think the message, by looking at it, and maybe, comparing Chile, is that we should do what countries that are succeeding do, not what countries that are failing do.

So you can speculate about what is going to cause policies to change, but to me, countries and investors will look around and follow the policies that work. That is not to say that investors do not get worried when they see a policy change in one country that looks bad that another country might adopt it. But I think there is just as many who might view it the other way.

When I talk to people in the markets, I hear both sides. Actually, that is what markets are all about—differences of opinion. Every quote you get from one side, there has to be somebody on the other side of that market.

Senator BAYH. Indeed. How do you interpret what is going on in Brazil, then, if they have, as we have said, sound economic policies, and yet, they have had great turmoil here, a lot of it focused on the potential outcome of this election. Isn't there at least an element there of looking to—there is uncertainty about what path a new government will adopt. Is it possible to say that that is not exacerbated by what has happened in Argentina?

This man is saying that they are looking at contracts back and forth. What kind of policies a new government might be inspired to implement?

Mr. TAYLOR. I agree with you. There is uncertainty about the election.

Senator BAYH. Your position, that is all indigenous to Brazil. That is not affected by what has happened in Argentina?

Mr. TAYLOR. I think, for the most part, it is an issue in Brazil. It is an issue of what the new administration will do.

They will make their decisions like anybody else, on the basis of many factors. They may look to Argentina, but what they find might be a policy to follow which is more conducive to economic growth, by doing the exact opposite of what is done there.

But the uncertainty about what a new administration will do is there and I think that is the reason the policies on the inflation side, on the fiscal side, on the social side, have been good in Brazil. I think the markets would like to see good kind of policies continue. There is uncertainty about that, as you know, Senator.

Senator BAYH. Just to digress to the broader point that I was making initially that you returned to.

It is in some respects a dilemma. You cannot reward bad political decisions because you will just get more of them.

On the other hand, I think when we evaluate policy prescriptions, there is an element of realism in terms of what the society in question will tolerate. There is a threshold of pain beyond which you go, you are going to be self-defeating as well. Now how to strike that realistic medium, that balance, is the challenge, and it is not an easy one. But to ignore the need for a balance, I just think is going to be self-defeating, too.

Mr. TAYLOR. Yes. That is why I think that we have to be gradual as we implement these new ideas.

Senator BAYH. I think we have talked about contagion in the context of Uruguay, in the context of Brazil.

I was curious about one thing. We talk about interest rate spreads and absence of political contagion. I believe earlier this year, it may have been in August, Brazil's credit rating was downgraded to the point where only Argentina and Nigeria have a lower credit rating now. What is the market reflecting there? What are the credit-rating agencies reflecting there?

Mr. TAYLOR. I would say the same thing the markets are, this uncertainty about what will happen.

Senator BAYH. In your opinion, it is mostly indigenous to Brazil. It is not a heightened risk premium.

Mr. TAYLOR. Chile is right next door to Argentina. They remain with investment-grade rating. Mexico is investment-grade rating and their policies are good.

I think you have to look at those cases, too.

Senator BAYH. Let me shift gears for just a moment and ask you about the IMF and our relationship to the Fund. I am told the top five borrowers now have 80 percent of the Fund's exposure, which is the highest concentration in history. Is that a prudent level of risk to run?

Mr. TAYLOR. That is a measurement of the existing loans that are out there. There is a lot of liquidity that the IMF still has.

Senator BAYH. It seems like a pretty high concentration.

Mr. TAYLOR. What you say is completely true. There are a lot of other Fund programs, but they are very small. The large fraction is in these countries. It does not represent a risk element of the kind that the figures indicate because the IMF has not lent out all the funds that it has. There is a lot of liquidity that is there, if you like.

Of the loan portfolio, it is out there and disbursed. It is concentrated. But I think you need to view that as part of a broader portfolio, funds which have not been disbursed.

Senator BAYH. How much of their available funds has been disbursed? I do not have that figure.

Mr. TAYLOR. The figure is approximately 30 percent. I believe 25 or 30 percent. I will have to get back to you on that, Senator.

I know they have about $90 billion that is in liquidity at this point in time that can be used for further programs.

Senator BAYH. Let me ask you another question with regard to our relationship with the IMF. And I know that you get criticized either way. If you are too aggressive, you get criticized. If you are too passive, you get criticized.

There is an impression on the part of some that this Administration has been a bit more passive in attempting to suggest what the appropriate policy might be to the Fund.

As the largest shareholder, what should our relationship to the Fund be? Don't we have some obligation to determine what we think is sound policy and urge them to adopt that? If so, have we been doing that?

Mr. TAYLOR. Most certainly, we have a responsibility and we have been doing that. We are in close contact with Fund management. The Secretary has regular meeting with the managing director of the Fund. I have close contacts with the management. The staff interacts an awful lot. And, yes, we are very engaged with the Fund.

I do not think there is any substitute for that, Senator. I wish there were, but it really is the kind of thing where you have to occasionally get into the details and look carefully at a program and go over there and talk and get the numbers out. I do that myself. I think it is very important to do it. I would not describe the relationship as passive.

We would like to have the Fund accountable for its decisions and responsible for its decisions. But that does not mean that we cannot be engaged.

And if I could just say one more thing on this. In the broader group of international financial institutions, we are trying to have our executive directors get engaged more with the development of programs and loans and not wait until they come to the board and have to vote yes or no, but actually get involved in the creation.

When I was just recently in the Philippines at the Asian Development Bank, I spoke to the President about having our Ambassador there get engaged at a very early stage in the development of loans and grants. They have agreed to do that.

That is just an example of how I think in order to affect the institutions in a positive way, you just cannot wait until the things come to the board and say up or down.

So, we are doing that, big time.

Senator BAYH. Certainly, in my opinion, we are not hesitating to express our preferred policy to the United Nations these days. I cannot see why the Fund would be much different.

I agree with your statement. You would take exception to the characterization that we have been more passive with regard to the Fund.

Mr. TAYLOR. Yes, sir, I certainly would. Yes.

Senator BAYH. One last question with regard to our relationship to the Fund. And then I am going to get to the other panel. But at least we will spend some time on the alternative debt restructuring mechanisms because that was part of the agenda here today. About fixed exchanged rates. What should the policy be with regard to that? What would you recommend regarding currency boards like Argentina's? And if they appear to be unsustainable, do not just postpone the day of reckoning with greater consequences at the end of the day?

And forgive me. You had something in your statement that alluded to what your answer might be. But I thought we would flesh it out a little bit. You say most countries now maintain ". . . float-

ing exchange rates, helping them to adjust more easily when faced with economic shocks."

Mr. TAYLOR. Yes. I believe that flexible exchange rates are better than these pegs that had existed and were more common in the past. And we are moving to a very healthy, greater degree of focus on keeping inflation low, and that frequently means that the exchange rate is going to be more flexible.

However, I do think that there are good cases where you can have a very credible connection to another currency. And one example of that is El Salvador, which had dollarized very successfully.

And that is kind of the other extreme, Senator, where you have locked into another currency and you can benefit from that. That creates its own type of stability.

The problems are in between the flexible and this super-strong connection. And I think that is the good thing about what is happening, and maybe the reason why there have been fewer crises so far, and I hope that continues in terms of the number of countries, is that there is more floating and more focus on keeping inflation down.

Senator BAYH. And as you know, there is this—I will call it a theological position out there that fixed-exchange rates are good in almost all cases. We have learned from hard experience I think that sometimes that is not true.

Mr. TAYLOR. Yes. This is an area where I think theology does not really help you very much.

Senator BAYH. It is not the only area where you get into religious debates these days.

[Laughter.]

But certainly one of them. Just two final questions and then let us turn to the debt restructuring alternatives.

I would like to ask you about one other dilemma that occasionally comes up, Mr. Secretary. You said in your testimony that not every crisis results from a fiscal deficit, for instance. And so, not every program should automatically require fiscal retrenchment, an eminently sensible statement.

What do we do in cases, and there are some, where there is no doubt that a lack of fiscal discipline is a part of the long-term problem, part of the underlying difficulty that is affecting an economy, but in the short run, demanding fiscal rectitude may exacerbate the economic downturn that we are attempting to pull the country out of. What do you do about a situation like that? There are a couple of them out there.

Mr. TAYLOR. Well, when you make reforms, which is really what you are talking about, reforming of fiscal policy toward a sounder approach, there is always a question about how rapidly to do it. And I think that that is really the way to answer your question.

If in the particular circumstance a country can get out of these fiscal problems, but it needs to do it over several years rather than overnight, and it can continue for several years, then that would be a way to alleviate a lot of the pain.

I, at one time, did calculations that if a country could very credibly commit to a gradual reduction in the fiscal deficit, that it would begin to have its own positive effects right away because it

would see that there is going to be less borrowing in the future. That could bring interest rates down.

If it could credibly do that, it could alleviate a lot of the pain. And I would certainly encourage countries that can achieve that credibility to do so. But we are still in a situation where there is really not enough fiscal responsibility in many countries, and I just want to talk about globally at this point.

We still have a problem with debts. Interest rates the countries have to pay are still too high, and that is because of these problems on fiscal responsibility, primarily.

I would certainly like to talk more about how important it would be to have sound fiscal policies.

Senator BAYH. Well, a lot of it gets back to political credibility. The last time you were here, we were focusing on Argentina, and there has been a real problem there with pronouncements that sound good, but they are never implemented.

And so, I think that the posture that we have adopted at the time the provision of assistance with the actual implementation of reforms is a very judicious course of action.

But you do hear these criticisms out there of the Fund that occasionally prescribes fiscal discipline at a time of economic contraction which, the argument goes, only exacerbates the problem.

Mr. TAYLOR. I hear that criticism and it is an example of one reason why we want to be in close contact and would want to look at the programs carefully to make sure that it doesn't happen.

Senator BAYH. At the same time, they have to make better long-term fiscal decisions to ever really have a sustainable recovery.

So it is a balance, and I am glad to hear your answer on that.

One last aside, and then let us get down to the issue of CAC's and SDRM's, just briefly. And to the other panelists, I thank you for your forbearance here.

The President of Colombia was in town a couple of weeks ago. I was very impressed with President Uribe. We have clear U.S. interests implicated there and a host of challenges, in addition to economic ones.

This gets me into another area. When, if ever, is it legitimate to consider geo-political factors in addition to economic ones? As you are aware, some people have suggested that played a role in the case of Turkey, possibly Pakistan. We now have Colombia, which has in the past attempted to pursue sound economic policies.

When President Uribe outlined his prescriptions for dealing with the host of challenges, they seemed eminently sensible to me, but politically very difficult.

I cannot claim to be a student of the Colombian political scene, but if we were attempting to do some of these things in this country, I can know how difficult it would be.

When is it appropriate to consider noneconomic factors in the provision of assistance? And was that an element in the case of Turkey and Pakistan?

Mr. TAYLOR. Well, speaking generally, there is, of course, a big role for assistance to countries for reasons that are political or are security-related. There is no quarrel with that at all. But what we need to try to do is to make sure that that assistance is not counter-productive with respect to the economic side of the policy.

That is, I think, something that we are emphasizing a lot. You mentioned Colombia. In Colombia, the President is taking on a real challenge and we want to be of assistance. We hope we can help his country economically, too. But we want to make sure that our support for the economy is because the economic policies are good and that that can help the economy and focus, if you like, the security assistance on these other areas. So it is difficult to separate, but I believe we can and we should keep trying to do it.

The same thing is true in Turkey. The assistance for Turkey in the past has been certainly related to security issues. But what we need to do is have our economic assistance based on how we can support them economically.

One last example of this is this Millennium Challenge Account that the President has proposed. That economic assistance is supposed to be based on policy. That part, that new money, is supposed to be on economic policy grounds, economic growth, not on the other issues that you mentioned. And I believe it will be if we adhere to the principles that the President wants to follow and that you want to follow. But that does not mean that our other assistance is not sometimes going to go for issues related to security. But there is a way to separate the two.

Senator BAYH. Do you consult with the State Department, or the Defense Department, with regard to those aspects of assistance?

Mr. TAYLOR. We have a lot of good discussions and a lot of coordination with Defense and State and Treasury in the Administration, yes, on exactly these issues. Yes.

Senator BAYH. Thank you.

Mr. Secretary, let me just ask one or two quick questions because we are going to have a vote coming up at noon and I want to give the other panel a fair amount of time. I do not have to leave at noon, but I have to leave shortly thereafter.

You have been associated with the collective action clause initiative. The Fund leadership has been associated more with the sovereign debt restructuring mechanism. Can you just briefly discuss the comparative advantages or disadvantages of the two approaches, and tell me, are they mutually exclusive, or might there not be some way to move along parallel tracks here?

I know some have suggested that because it would take Congressional action, the sovereign debt approach might take a little longer, so you try and encourage the CAC's in the shorter run. What are the comparative advantages and disadvantages in your mind of the two?

Mr. TAYLOR. One important advantage of the collection action clause is we can move those very quickly. We are encouraging the issuers in the private sector to do that.

Last April, we outlined some basic parameters that we think these clauses should have. The majority action, so that there can be a change in the terms, some representation of the creditors, some way to deal with legal actions in a way that is constructive. And the private sector is actually working quite well to pursue that, I think. It has been a much more positive response to that approach than we have heard in the past. As I said, these kinds of things were first suggested in 1996.

So that is the advantage. I think the purpose, just to be very sure, is to make the process more predictable, to make the markets work better. We do not want to encourage default in any way. We do not want to increase the cost of it, do not want to increase the likelihood. It is to make the restructurings more orderly when they occur. The sovereign debt restructuring mechanism requires statutory changes. As you say, that means it will take a longer period of time.

Senator BAYH. Are you suggesting that the Congress cannot act quickly, Mr. Secretary?

[Laughter.]

Mr. TAYLOR. There are a lot of legislative bodies in the world that are required here.

Senator BAYH. Mexico made a statement not long ago that they were not inclined to incorporate CAC's. Is that because they fear higher interest rates will be required? And if so, what do you do about that if the issuers—they do not perceive it as being in their interest to include them, and therefore, do not?

Mr. TAYLOR. Well, some issuers have already indicated a strong interest in pursuing it. For example, Russia, South Korea, have been positive about it. But the concerns that countries raise, and you mentioned the example of Mexico, is exactly that, that the costs of borrowing will be higher.

The evidence, however, suggests that that need not be the case. For example, there are collective action clauses in the United Kingdom markets. They exist. The studies that have been done do not see that they are more expensive. In fact, for good performers like Mexico, such clauses reduce the price of borrowing.

I think there needs to be more discussion on this. In the meantime, some countries are interested in pursuing it in the New York market. The New York market is where these do not exist. They do exist in London. We want them to move ahead in the New York market, and I can see some interest in it at some point.

Many emerging markets have indicated strong reservations about the sovereign debt restructuring mechanism approach. But with respect to collective action clauses, there is much more enthusiasm at this point in time, and we should welcome it.

Senator BAYH. On the part of the lenders?

Mr. TAYLOR. On the part of the lenders, certainly. We should welcome that, which we are.

At the same time, I think from a public policy point of view, we want to consider what an alternative would be, what the sovereign debt restructuring mechanism would look like. We haven't seen a complete proposal about it yet. And that is one of the reasons why we are still discussing it.

Senator BAYH. Last question, and then one closing comment.

Is this made more difficult by the fact that a lot of the borrowing today is in the form of bond issues, as opposed to bank loans? Doesn't that complicate the issue here a bit?

Mr. TAYLOR. It is more complicated because there is more diffuse holdings of the securities. And people all over the world, small investors—that makes it more difficult. That is why these clauses will make a big difference, because it is a way for voting to take place if there needs to be a change in the terms.

Senator BAYH. There is enough institutional holding, though, that you could still get a super-majority sufficient to move forward under these clauses?

Mr. TAYLOR. Yes, we believe there is.

Senator BAYH. Okay. My last comment. First of all, thank you for your time, Mr. Secretary.

Mr. TAYLOR. Sure.

Senator BAYH. You have been very generous. I would simply say, and I think you have outlined that this is your desire as well, let us pick a policy and stick with it. Make it as transparent as we can, with as much objective criteria as we can. I think that lowers the uncertainty and reduces both the risk of contagion and moral hazard. That really was the purpose behind the hearing today. So, I urge you in that effort and look forward to continuing our work together.

Mr. TAYLOR. Thank you very much, Mr. Chairman. I appreciate your last remark particularly.

Senator BAYH. Thank you.

[Pause.]

Thank you very much, gentlemen, for your patience. The first panel took a little bit longer. We had a lot of ground to cover.

Why don't we just move from your vantage point from the right to the left, starting with you, Mr. Tarullo, then to Dr. Mussa, and finally, Mr. Otteman.

By the way, Dr. Mussa, I indicated before you arrived, I got a good chuckle about reading about your cat last night.

[Laughter.]

I thought there were definitely some analogies to be drawn there. It is not often that I get a chuckle out of testimony before the panel, but it was welcome. Thank you.

Mr. Tarullo, let us begin with you. I think, as he suggested, the Chairman did a good job of drawing upon some of your comments in his questioning. And so, given the hour, please go ahead.

STATEMENT OF DANIEL K. TARULLO
PROFESSOR OF LAW
GEORGETOWN UNIVERSITY LAW CENTER

Mr. TARULLO. Thank you, Mr. Chairman. Let me say just a couple of things, because Senator Sarbanes did point to one issue I wanted to raise.

The another point I wanted to make, which I will state briefly here, is what is really at stake in the issues implicated in this hearing.

I think it is really nothing less than the medium-term direction of economic policy in South American countries. It was, not quite 8 years ago that the leaders of all but one of the countries in this hemisphere met in Miami for the Summit of the Americas, hosted by President Clinton. At that time, the sense of optimism and sense of engagement were really quite extraordinary. And here we are, fewer than 8 years later, feeling quite nervous about both the political and the economic direction of Latin America.

Now, we can sit here and worry about it. The question is what can we do about it? And that is where your hearing plays an im-

portant role, because you are focusing attention on the existence and implementation of coherent policies.

In my judgment, both the Administration and the Fund need to be rather more proactive than they have been. So, it seems to me, that in addition to the problem of coherence which you and Senator Sarbanes pointed out before the earlier panel, that we do have a problem of a certain absence of proaction.

I believe that the Administration needs to help Argentina find a way out of its economic calamity and do so in a way that indicates a continuing effort by the Administration to come up with a menu of policies that might help the country move forward. I think simply waiting by the phone, although an admirable effort at restraint and nonimposition of policies, leaves a confused government in a confused state.

I also think we need to help Brazil find a way into successful regional integration. And that two counsels continued engagement and continued efforts on the trade side, as well as on the financial side. But there again, I think our presence needs to be not just privately indicated, I think it needs to be publicly apparent as well.

In the case of the Fund, Senator, there is a certain irony here. For years, many people, myself included, have been critical of the Fund for an excessive focus on fiscal policies or on exchange rate policies or an excessive imposition of conditions for IMF resource programs.

The histories of Argentina and Brazil—as my fellow panelist, Mike Mussa's work has quite successfully shown—may indicate an insufficient attention on the part of the Fund to some unsustainable policies that go against the grain of the Fund's own predisposition: The long-term run-up of debt and the fixed exchange rate policies, were problematic.

But that observation does raise the very delicate questions of sovereignty and how much intervention we do want the Fund or the U.S. Government to make in these circumstances. And that is one issue where I do not think there are any clear answers and I do think a continuing dialogue in fora such as this are quite important.

Finally, Senator, as you know, and Senator Sarbanes has said on many occasions, Congress cannot make policy on a day-to-day basis. That is why you have an oversight function.

But it does seem to me that this is a little bit like chairing an interagency meeting.

I always found that Treasury, State, and the other agencies were somewhat resistant to programs coming from White House staff as to what they should do. However, if you called a meeting, asked a question, and threw a piece of paper on the table, the chances were that by the next meeting, the agency would have its own program addressing the same kind of problem that you wanted them to address. And I think a hearing like this does very much the same thing and thus I applaud and appreciate your conducting it.

Thank you.

Senator BAYH. Thank you very much, Mr. Tarullo.

Dr. Mussa.

STATEMENT OF MICHAEL MUSSA, Ph.D.
SENIOR FELLOW
INSTITUTION FOR INTERNATIONAL ECONOMICS

Dr. MUSSA. Thank you, Mr. Chairman.

Senator BAYH. Elmer.

Dr. MUSSA. Elmer the cat, yes. Actually, he had a longer name—Elmer Aloysius Alcibiades Yenom, but we won't get into that.

Senator BAYH. Family name?

Dr. MUSSA. No. Yenom is money spelled backward, so it is not entirely irrelevant to the Banking Committee.

[Laughter.]

I have a long written statement and an oral statement that you have already quoted from and that Chairman Sarbanes has already quoted from.

Let me discuss three main points.

The first point, quite briefly, the obvious inconsistency between the Administration's rhetoric on large financial support packages and the fact that they have supported an awful lot of them.

To clarify one key fact, we really have had bigger packages more frequently than in the past. Take the case of Brazil. There was a $15 billion precautionary package now most of which has been drawn. To that has been added from the IMF another $30-plus billion. So the total is $45 billion from the Fund alone.

Forty-five billion dollars was the largest previous package also for Brazil, consisting of $20 billion—this was in 1999—from the Fund, about $10 billion from the World Bank and IDB, and another $20 billion from bilaterals.

Now, we have $45 billion just from the Fund, plus another $8 or $10 billion, I do not know how much additional money from the IDB and the World Bank. So there is no doubt that the present official support package for Brazil is the biggest in history. And it may well get bigger.

Second point in this area, in addition I believe to the problems that you have already discussed about the inconsistency of policy, I think there is a substantial problem that this inconsistency has contributed to poor management of actual financial crisis.

And here I disagree very much with Secretary Taylor. The decision made in August 2001, to augment international financial support for Argentina was the worst single decision made in the 10 years that I was at the IMF. By that point, it was clear that they were headed down the drain and they needed to do a restructuring.

Common sense suggested officials who were ideologically opposed to large assistance packages are poorly qualified to make decisions concerning their design and implementation.

Senator BAYH. Clerics make poor economists? Is that the case?

Dr. MUSSA. Well, I think it is rather like asking a conscientious objector to serve as the commandant of the Marine Corps.

Now, turning to the situation in Uruguay and Brazil, which was also on your list of questions. There is no doubt that Uruguay was going to suffer substantial either contagion or direct effect, whatever you want to call it, from Argentina. Nevertheless, little was done to help Uruguay until this spring, when large bank withdrawals and capital outflows caused the collapse of Uruguay's crawling exchange rate peg regime.

Then IMF support was rapidly augmented to roughly five times the normal limit. But this was not enough, and in August, further official support, not just from the Fund, up to a total $4 billion was committed.

For the time being at least, this solution of throwing more money at the problem has contained the crisis. But it is still unclear whether Uruguay can get through its present difficulties without a comprehensive debt restructuring. And this is an issue that has just not been consistently faced yet.

For Brazil, so far, the international community has adopted a more sensible approach to a difficult situation. We had a precautionary package more than a year ago and this summer, when more pressures came, as Secretary Taylor indicated, another $30 billion was added, in the very useful form of a little bit of additional money now and a substantial commitment provided the new government was prepared to continue with sound policies.

That was the right decision because delay until after the elections has been essential to get a government elected that will have to take the key decisions for Brazil going forward.

In my view, however, the present policy path featuring Brazil's continued commitment to moderately strong policies backed by substantial official support is a prescription for disaster.

As reflected both in interest rate spreads on Brazilian bonds and the exchange rate on Brazil's currency, financial markets see this approach as woefully inadequate, and the market will make this assessment a self-fulfilling prophecy.

There are two viable approaches, one based on prompt recognition that comprehensive restructuring of Brazil's internal and external debt is unavoidable and needs to be managed with as little economic and financial disruption as possible.

The other is based on substantially strengthened economic policies, including a primary budget surplus of at least 5 percent of GDP backed by measures to constructively involve Brazil's private creditors and supported by a meaningful increase in committed international assistance.

If another catastrophe like Argentina is to be avoided, tough decisions soon need to be made, with the clear recognition that the middle ground is untenable.

Finally, much attention has recently been focused on the issue of the SDRM. I am highly skeptical about this proposal for two key reasons.

First and foremost, if a workable SDRM had existed, it would have done little material good in helping to avoid or resolve the major emerging market financial crises of the past decade. I count 10 of them. Only in the present crisis in Argentina has default by a sovereign on its foreign law debt been a major issue. In the other nine, the SDRM would not have been relevant at all. And for Argentina, while there is a large default and a few suits have been filed, legal actions have not been a factor at all in Argentina's economic collapse. GDP dropping 25 percent, it is not because of legal actions.

Second, and this is where Elmer comes in, while it is arguable that an SDRM can be moderately helpful in some situations and

is worthy of further study, there is good reason for caution in moving forward.

Those most concerned with emerging market debt, its issuers, its investors, and its dealers, generally oppose an SDRM, and some very strenuously. Their analysis may be wrong, or their motives may not be entirely pure, but their concern should not be lightly dismissed.

Moreover, in considering the SDRM, I do point to the Elmer principle. Elmer was a docile and affectionate feline, except for the ferocity he displayed in confronting other male cats. In dealing with this problem, my father, who was a wise man, advised, it is usually a mistake to try to referee a cat fight. You are likely to get scratched and bitten, and your intervention is generally not appreciated by the principal participants.

Disputes in a sovereign default are much like a huge cat fight, with many hissing and howling combatants and their lawyers. The international community, whose own motives may be questioned and whose authority is limited, should think carefully before volunteering to referee such affairs.

Senator BAYH. Thank you, Dr. Mussa. He will be forever memorialized in the annals of the *Congressional Record.*

[Laughter.]

Mr. Otteman.

STATEMENT OF SCOTT A. OTTEMAN
DIRECTOR OF INTERNATIONAL TRADE POLICY
NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. OTTEMAN. Chairman Bayh, I am pleased to be here pinch-hitting, as you said, for Frank Vargo, my boss at the NAM, to talk a little bit about the effect on U.S. business from the crises in Latin America over the last couple of years.

I particularly want to talk about how this affects not only U.S. business, but also U.S. jobs and the U.S. economy.

The subject of today's hearing, Argentina's economic and political crisis and the spillover effects to its neighbors, has immediately affected U.S. companies in two clear ways.

First, it has provoked a dramatic decline in U.S. exports to South America. Second, it has substantially harmed the conditions for doing business faced by U.S. firms that are invested and operating in the region.

United States exports to Central and South America so far this year have fallen 16 percent from the same period a year ago. The three largest proportional declines were to Argentina, Uruguay, and Brazil.

United States exports to Argentina have plummeted a stunning 67 percent, dropping from an annual rate of $4.5 billion to $1.5 billion, a $3 billion fall. Exports to Argentina face a triple whammy. First, there is low demand due to 4 years of recession and depression in that country. Second, they face a huge competitive disadvantage due to the 70 percent devaluation of the Argentine peso, which, as you know, makes foreign imports much more expensive than similar domestic goods. And third, there are import curbs imposed by Argentine authorities to improve the country's current account balance.

United States exports to Uruguay, meanwhile, have fallen 53 percent and exports to Brazil have dropped 26 percent, from an annual rate last year of $16.5 billion to $12.2 billion so far this year.

The Commerce Department estimates that each $1 billion of exports supports approximately 12,500 U.S. jobs. This implies that the export losses over the last year to Argentina, Brazil, and Uruguay may have impacted over 90,000 American jobs.

With respect to United States investment in South America, the income earned on those investments has dropped precipitously. For instance, United States foreign direct investments in Argentina, the worst case, have lost $2 billion in the last 9 months alone.

Given the depths of Argentina's crisis, it makes sense that those U.S. businesses with operations in Argentina are the ones that have been most severely hurt. I refer you to my written testimony for a fuller description of some of the crisis-related measures taken by Argentina's authorities, which continue to impair companies' abilities to function without suffering substantial losses.

Perhaps the longer-term danger the current situation poses for United States business and for the common interests of Latin America and the United States is the emerging perception among the people and politicians of the region that financial crises and economic stagnation are somehow caused by free-market reforms.

Here, I think I am a little less sanguine than the Under Secretary was in the sense of there being potential copy-cat effects of politicians looking at the inability of the reforms so far to produce the desired results.

Senator BAYH. The danger of political contagion that he and I were talking about?

Mr. OTTEMAN. Yes. In our view, however, any attempt to turn back the clock by returning to an import substitution model or other policies of the past will be a costly mistake. Although, in hindsight, some of the reforms of the late 1980's and 1990's perhaps could have been carried out more gracefully, maybe at a different pace or in a different sequence, the main problem continues to be not that reform has gone too far in Latin America, but rather, that the reform process in many cases has not yet gone far enough.

A few words about Brazil in light of its size and the extent of United States private activity there.

If financial collapse were to spread to Brazil, the potential negative impact on U.S. business would be vastly enlarged. Some 400 of the United States *Fortune 500* companies have operations in Brazil. A Brazilian financial disaster such as Argentina's would not only undercut the operations of United States firms invested in and trading with Brazil, but also could spread investor panic and depress growth prospects throughout Latin America and perhaps the rest of the developing world, similar to what we initially saw with Mexico in 1994 and with Asia in 1997. In my opinion, though, this unwelcome scenario is far from inevitable and certainly can and must be avoided, if at all possible.

U.S. policymakers and the international financial community have important roles to play in avoiding this type of disaster. I will leave it to my co-panelists, who have hands-on experience in these matters, to make recommendations to the U.S. Government and IMF. However, the experience of our members who are inter-

national traders and investors leads us to believe that the most critical role in avoiding such a crisis will inevitably fall to Brazil itself. Regardless of who wins the October 27 presidential run-off, the new Brazilian President can do much to allay the concerns found in financial and business circles today.

For example, he might appoint an experienced economic team that understands international finance and recognizes the importance to Brazil's future of deeper and broader integration into the world economy. He could also make it manifestly clear that his government will honor its international debt and other obligations. He could reaffirm Brazil's commitment to successfully negotiate a Free Trade Area of the Americas by the agreed deadline of 2005.

Once the immediate threat of financial crisis is averted in Brazil, Argentina, or elsewhere, there are additional steps that must be taken to achieve a stable democratic and prosperous Western Hemisphere. I will just mention one. That is, this idea of the Free Trade Area of the Americas being reinvigorated now that the United States has Trade Promotion Authority.

Senator BAYH. Thank you, Mr. Otteman. Forgive me for interrupting. That buzzer you just heard, I think, was them calling a vote, which means I have about 10 or 12 minutes before I dash over there.

Would you mind if we submitted the rest of your statement for the record and I went to some questions for the panelists, yourself included?

Mr. OTTEMAN. Certainly, Mr. Chairman.

Senator BAYH. Thank you very much. I appreciate your willingness to do that.

Senator BAYH. Mr. Tarullo, moving quickly, you heard the Under Secretary say that, in his opinion, the phenomenon of contagion was really not what it used to be for a variety of reasons.

I think I know what your reaction to that will be. Can you give us your opinion?

Mr. TARULLO. Senator, in my judgment, the nature of contagion depends on the nature of the financial crisis. It is obviously the case that we do not have the situation of the mid- to late-1990's when there was a lot of short-term portfolio investment around the world which could flow out very quickly. That was the kind of contagion that we experienced in the 1997–1998 period.

Although it is important to be analytically careful to distinguish different reasons for different kinds of contagion, it is equally important to address the effects that actually are entailed. And that is where I fear that there is a certain acquiescence by the Administration in things that they call interconnectedness, or political contagion. These are all phenomena that have the effect of spreading economic problems and thus they all require a response.

Senator BAYH. Without getting into semantic arguments, the point here is that they are contagion, nonetheless. Different forms, different types, but they are destabilizing to the local economies. They spread to other nations and eventually affect our interests. Is that correct?

Mr. TARULLO. That is correct, Senator. And to the degree that the contagion is so-called real economy contagion, or what the Secretary called interconnectedness, that is a lot easier to predict. It

did not take a lot of analysis to know that Uruguay was going to have problems when Argentina went into a financial crisis because all the Argentine citizens have their money in Uruguayan banks.

Senator BAYH. But we waited, and then had to come up with a much larger package in the event. Correct?

Mr. TARULLO. Correct.

Senator BAYH. Postponing the day of reckoning only sometimes makes it more difficult.

Mr. Otteman, for your members, this is not a theoretical issue. It is a real issue. And as I understand your testimony, you see a risk for premiums for doing business in other countries being affected by all of this. Correct? Politically and otherwise? Argentina is having an impact on American businesses attempting to do business in other Latin American countries. Is that correct?

Mr. OTTEMAN. I do agree with the Under Secretary that the main effect has been the trade effect with the neighboring countries and that you have not seen the spread. But with Brazil, there could be a much greater potential for that in terms of the size of the economy and the size of the United States company involvement there.

Senator BAYH. Mr. Tarullo, back to you, and then possibly to Dr. Mussa.

The Under Secretary was admirable in his attempts to defend the consistency of the policy over the last couple of years as it related to some of the statements that had been made.

But it does seem to me, and I think to Chairman Sarbanes, that there has been a certain amount of cognitive dissonance, shall we say, within the Administration which has led to some inconsistencies and therefore, higher costs and greater problems.

Hence, my request that he pick a policy, let's stick with it. We are going to have fewer problems if we do that. Is that your impression as well? There has been some cognitive dissonance here? And if so, what do you think accounts for that? Is it ideology running into real-world problems?

Mr. TARULLO. Senator, I do agree with you. Let me start with a somewhat more sympathetic note for the Administration.

These are not easy problems. There are no simple solutions out there. And one thing I think we can applaud the Administration for doing is resisting in practice simplistic solutions that have been urged upon it.

Senator BAYH. That would be the more absolutist ideological approach. Correct?

Mr. TARULLO. Correct. And indeed, the risk is that one adopts a rhetorical position that seems highly principled, some might call ideological, and then rather regularly departs from those principles in practice.

It seems to me that that gives you the worst of both worlds because the markets and other governments are not able to plan based upon your stated policy, and then they cannot see the relationship between what you actually do and what you say.

Senator BAYH. Uncertainty has real-world costs.

Mr. TARULLO. Correct. And Senator, that is not to say that there needs to be absolute consistency and a kind of hard-line that people just stay with. Evolution and flexibility, sure. But the markets and, other governments need to see a strain of consistency in a policy.

Senator BAYH. Rhetorical consistency would be beneficial as well. I think as Chairman Sarbanes was exploring in some detail, there have been a couple of cases where statements have been made that were not helpful. Let us just put it that way.

Dr. Mussa, why the inconsistency in your opinion?

Dr. MUSSA. Well, I think, as you suggest, I would divide it into two problems.

One, I think there have been some unfortunate statements that have been made in less than formal context, which I think should have been regretted at the time. And two, I think the other problem has been substantive, that the policy really has not been clear. There has been clear rhetoric opposing large packages and there have been a lot of large packages.

[Laughter.]

That is the reality that you need to do something about these crises, even if it was not what you were thinking before you were in office. But this is not just a perception that I have.

Senator BAYH. Forgive me for interrupting. Has the ideological reluctance to intervene, when forced to be confronted with reality and forced to change, has that contributed to the increased size of these packages?

Dr. MUSSA. Well, I think that is a very difficult judgment to make. There are 6 or 7 instances.

I do think geo-political considerations have clearly played a very important role in Turkey, and particularly after September 11. Whether Secretary O'Neill's comments and the reactions to them induced a larger Brazilian package or not, I do not know. I think that that package, backloaded, was the right thing to do in the circumstances, whether or not there had been any such unfortunate remarks.

I would note that this problem is not just in our perception. I quote Peter Costello, the Treasurer of Australia, from his official release statement to the IMFC.

> What counts is what the Fund actually does rather than what it says it will do. Ultimately, as the quality of the judgments that are taken in each case and whether the frameworks are applied consistently which will determine whether the Fund is successful in helping to resolve crises.
>
> In effect, each decision will be part of an ongoing process of defining the role and success of the Fund. It is important that its actions are consistent with the stated intentions.

This has not always been the case.

Senator BAYH. The market players look at the actions, not just the rhetoric. But consistency of both would be helpful and it has been problematic in both cases. Is that a fair summary?

Dr. MUSSA. I think so. And also, in the 20 meetings of the IMFC and its predecessor committee that I attended, long and boring meetings, that is as explicit a criticism in an official statement as I have ever seen.

Senator BAYH. Well, candor can be refreshing. Beneficial at times, too.

Let me shift gears to Brazil, Dr. Mussa, starting with you, and them Mr. Tarullo.

You said that the markets have priced—and the status quo is heading us down a very dangerous path here. You said tough decisions will be needed. You outlined a couple of different alternatives.

You are not a Government official, so you can tell us what you really think. Lula is likely going to win the election. Will he be willing to make the tough decisions that, in your opinion, are required to rectify the situation?

Dr. MUSSA. I am really not certain. It would be very difficult for him because it would require backing away from a number of his key campaign pledges and a number of positions that he has held for many years, wanting to increase public-sector investment, wanting to do, in effect, fiscal expansion to generate employment, wanting to raise the minimum wage, and other things.

Senator BAYH. You are talking about running a surplus of up to 5 percent. Is that the kind of thing that the government would be likely to do?

Dr. MUSSA. Well, right now, the primary surplus is a little below 4 percent. So it is a matter of—you have to send a signal that shocks the market into believing that you are actually going to follow a significantly different policy path than they are anticipating and that it is built into current market interest rates and prices and the exchange rate because, as Mark Twain observed, "it is hard to build a reputation on what you are going to do."

So if it is a promise of what policies are going to be 2 or 3 years down the road, it doesn't mean anything. They need to see you deliver it.

Senator BAYH. Speaking of that, how did you interpret the dramatic and unexpected rise in interest rates yesterday?

Dr. MUSSA. The Central Bank, which has been keeping with the Selic rate, which is the overnight interest rate in the interbank market, down at 18 percent, finally had to give that up because the government was not able to roll its debt and the exchange rate was sinking through the floor. So, they kicked the rate up to 21 percent. That is not going to be enough. But it is the signal that they are running out of room. And much of the Brazilian debt is domestic, much of it is linked to the Selic rate. Once they get in the business of pushing the Selic rate up and it reached 45 percent in early 1999, it is going to be clear that fiscal sustainability is an impossibility. So the signal that they have already needed to take the first step down that road, was not a reassuring one.

Senator BAYH. Mr. Tarullo, what is going to happen in Brazil and what do we need to be doing about it?

Mr. TARULLO. Well, Mr. Chairman, like Mike I would not want to make a prediction, not because of an unwillingness to make predictions, but it is just a very difficult situation.

Senator BAYH. Well, let me phrase my question a little bit differently. You pointed out that we waited a little late in the game to address Uruguay. Let us learn from that experience.

Mr. TARULLO. Here is, though, what I think that we can do. Let us hope, and we can hope, that everything breaks right: The debt can be sustained without restructuring. Brazil will get back on a path of economic growth and there will be a strong and stable government.

Having said that, we know that in the real world, things do not always break right. So what can we be doing right now? I think that maintaining the package that was put in place is a good idea. I think it needed to be done.

I was disappointed in the absence of the so-called private-sector involvement. It did not appear to me that the Administration or the Fund did very much to try to elicit more formal commitments on the part of private investors to maintain the rollover, or to make additional investments where appropriate. Instead, they accepted a rather loose—and so far as I can tell from people on Wall Street—not very well-observed commitment to maintain a presence in Brazil.

So, the first thing, I think we need to have done, and maybe we can still do, is to engage with the private creditor community.

Second, and related to that, is my point about the Administration's voice itself being an instrument of economic policy.

It is not dispositive. You cannot just say something and make it be true. But if the Administration does engage with the new president, whether it is Mr. da Silva or Mr. Serra (if he makes a comeback), and can get an understanding on a certain set of policies while at the same time understanding the political exigencies that the victor faces, then a positive signal will have been sent to the markets. Then the markets might—might—be willing to be a little bit more tolerant and a little bit more patient.

If, on the other hand, you have the election of a president who says, "I am going to change a lot of the things" and the Administration stands back and has no voice, then I fear that the markets are themselves going to fear the worst, the reason stated in Mike's Mark Twain quote.

Senator BAYH. So, you would argue for being more proactive, and it is your impression that the Administration to date has been a little too passive, that we should be more proactive in trying to define some sustainable economic policies?

Mr. TARULLO. Exactly, Senator. As I said in the prepared testimony, there is a wide spectrum between imposing policies, on the one hand, and just sitting by the phone. I think we need to be somewhere in the middle, and we need to recognize that by being somewhere in the middle we can actually elicit a very positive response from the country because they know we care about them.

Senator BAYH. Dr. Mussa, I am interested in your comments about this passivity.

I would just make one comment of my own, Mr. Tarullo. And that is, if you wait to be able to, "impose your policies upon another country," that ordinarily can only be done when the crisis of such magnitude, it is more difficult to correct.

Mr. TARULLO. Excellent point, Senator.

Senator BAYH. Yes, Dr. Mussa.

Dr. MUSSA. I think one has had to wait until the election is over because it is the new government that will have to make the decisions and implement them.

I do not think one can impose the decision. But I think that one needs to pose the question clearly and starkly. There are no easy, attractive options. I think proceeding with the present fiscal surplus, which is credible and significant, the market says, that is clearly not enough, not marginally enough, woefully not enough.

So the new Brazilian government is going to need to choose, do you want to do a restructuring internally and externally, which also involves private creditors as well, or do you want to go the

strengthened policy path with more official backing and involvement of private creditors, which also involves backing away certainly from many of Mr. Lula's campaign promises.

It is their choice.

Senator BAYH. Either course involves backing away.

Dr. MUSSA. Absolutely. It is their choice. But the notion that there is this kind of easy option in the middle, that I think does not exist and I think that the IMF and the U.S. Administration need to say clearly and forcefully, that option, although we would like it, if it were possible, is just not available.

It is your decision. It is a very tough one. And we will try and back you as constructively as we can once you have made it.

Senator BAYH. I apologize. I am going to have to run here, Mr. Otteman. I do have a couple of questions for you.

In a different context, it reminds me somewhat of the situation we faced in 1992. We had President Clinton coming into office, who had run on a modest fiscal stimulus program and quickly became convinced of the virtues of fiscal discipline, in bringing down the deficit at the time, followed that path with some remarkable results. But it did require a willingness to give up some previous statements and to turn against some natural constituencies. I am wondering if in our system, the ability to do that might be a bit greater than in the Brazilian political system.

But this gets back to my points that I emphasized throughout, the interconnectedness of sound economic policies with an understanding of what is politically sustainable within the culture and the country that you are attempting to help, and you get into some difficult decisions there.

So, as I said about the pessimist being the optimist with access to greater information, which is a nice segue to you, Mr. Otteman, you look at some of this information and it is very difficult to be optimistic.

But, Mr. Tarullo, I hope that you are correct with the optimism that you have given us here today.

Mr. Otteman, quickly, and I do apologize. I am going to literally have to run. How many American jobs do you think are at stake here, could be lost with more and more Americans depending upon exports abroad if the situation in Latin America continues to deteriorate? Do you have any estimates of that out there in the real world?

Mr. OTTEMAN. No, we haven't done any calculations beyond what the Commerce Department has done in terms of linking the export-related jobs to U.S. jobs.

Senator BAYH. But if Brazil were to fall into a situation of real crisis, I assume it would not be insubstantial, the number of American jobs that would be at risk.

Mr. OTTEMAN. I think it would be a multiple of the Argentine figure that we cited in the testimony.

Senator BAYH. This is a real-world problem that is going to affect real businesses in our country and working Americans, if we do not handle it as best we can. Correct?

Mr. OTTEMAN. Yes.

Senator BAYH. This is a matter that tends to end up on the back pages of business sections or is of interest to economists. But my

point is that people on Main Street are going to be affected if we do not get ahead of the curve here and learn from past experience and do a better job of trying to handle this one. Is that a fair observation?

Mr. OTTEMAN. Of course, yes. I pretty much agree.

Senator BAYH. Last question, and I apologize for having to run.

The business community has expressed some frustration about the lack of enough proactive intervention by the Administration, or attention by the Administration. What would you recommend? What would the NAM and its members recommend?

Mr. OTTEMAN. Well, we are not in the business of recommending really on these financial issues, at least I am not in a position to do that.

Senator BAYH. Just focus on it, come up with a policy and implement it?

Mr. OTTEMAN. Exactly. I thought the discussion between you and the Under Secretary was very helpful, and it seemed like you were both on the same page when it comes down to the bottom line. I hope that you would continue in that direction. But we are just hopeful that the crisis situation can be brought under control so that we continue to pursue in Latin America the broader policies that they need both for the benefit of their people and that we need to be able to do business there.

Senator BAYH. Thank you, Mr. Otteman. I apologize. I have been told I have one minute. I do not have on my track shoes, so I am going to need to move.

I do want to thank you, gentlemen. I appreciate your forbearance with regard to the time and your courtesy in arriving. Thank you very much.

Dr. MUSSA. Thank you.

Mr. TARULLO. Thank you, Senator.

Senator BAYH. We have benefited from your insights.

Mr. OTTEMAN. Thank you.

Senator BAYH. The hearing is adjourned.

[Whereupon, at 12:22 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF JOHN B. TAYLOR

UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
U.S. DEPARTMENT OF THE TREASURY

OCTOBER 16, 2002

I would like to thank Chairman Bayh and Ranking Member Hagel for holding this hearing to discuss United States economic policy toward Latin America and the role of the international financial institutions.

Strengthening United States ties and raising economic growth in the many countries of Latin America are central to President Bush's agenda, not only because we want to help our neighbors, but also because their stability is in our interest. The United States benefits directly from having strong neighbors and reaps tangible economic gains when the region fares well. But we risk losses when Latin America undergoes economic turmoil—not least because of the increasing integration within the hemisphere.

When I testified before this Committee last February, economic and financial conditions throughout much of Latin America, with the exception of Argentina, appeared to be picking up after the slow growth last year associated with the recession in the United States and the global slowdown. However, since then, conditions throughout the region became more difficult, and economic growth this year is likely to be zero at best. This is in contrast to other developing and emerging market regions where growth is positive this year—about 6 percent in Asia, 3 percent in Eastern Europe, and 3 percent in Africa. Clearly raising economic growth in the region must remain a high priority.

An Economically Diverse Region

Considering Latin America as a single entity overlooks its diversity—from extremely poor nations confronting difficult development challenges to economies with sophisticated financial markets. Some countries in Latin America are performing well economically; they have implemented good economic policies. Others are just beginning to implement good policies, and have much to look forward to. Still others have recently experienced crises or are potentially in danger.

Mexico and Chile's strong economic policies and sound political foundations have set them apart in the region. Chile remains ranked among the most open, competitive, and economically stable countries in Latin America—factors that help to explain its average annual growth rate of 6.8 percent throughout the 1990's, a figure well above the regional average of 3.3 percent. After experiencing high inflation (70 percent annual average) and near-zero growth throughout the 1980's, Mexico's economy grew by an average of 5 percent per year between 1996–2000 after its leaders had begun to implement a series of key free market reforms—including the North American Free Trade Agreement.

A number of countries are striving to implement strong economic policies, but still have a way to go to realize their full economic potential. El Salvador stands out among those that have made tremendous strides by pursuing sound policies, while Bolivia, Colombia, and Peru are also working hard to implement a strong policy mix that will enhance stability.

Other countries have experienced significant turbulence in recent months despite policy fundamentals that have generally been strong. The United States is closely watching Brazil and strongly supported IMF assistance in August because its economic policies have been strong. Events in neighboring Argentina contributed to significant difficulties in Uruguay this summer, but the Uruguayan authorities have responded strongly in cooperation with the international community.

Finally, Argentina is beginning to stabilize though it remains in crisis following significant deterioration in 2000 that culminated in late 2001 with a freeze on bank deposits, an end to dollar-peso convertibility, and a default on its debt. Argentina and the IMF are working to conclude an agreement in the near future that will help Argentina to strengthen its monetary and fiscal framework.

In the wake of Argentina's crisis, the experiences of different Latin American economies and other emerging markets have been instructive. In the months after Argentina's collapse, we saw little impact on other emerging market countries, even in Latin America. This stands in contrast to the effects of Russia's crisis in 1998, which was accompanied by immediate and sharp rises in the borrowing spreads for other emerging markets, even those that had few real links to Russia. It seems that in recent years investors have become more skilled at differentiating between countries and markets based on fundamental economic assessments. We have sought to promote a further evolution in this direction by emphasizing that policy decisions will not be based on unfounded claims of contagion.

We have, however, supported programs where there was direct or fundamental interdependence between countries—as in the case of the effect of Argentina on Uruguay—in order to mitigate such effects.

Improving Prospects for Productivity Growth

Raising living standards and expanding support for democratic institutions in Latin America depend critically on achieving higher levels of economic growth—a key concern in a region where one-third of the people live on less than $2 per day. The United States is working to help create an environment where the private sector can be the engine for productivity growth.

Productivity merits special emphasis because only by raising productivity—the amount of goods and services that a worker produces per unit of time with the skills and tools available—can countries raise per capita income. And the higher the rate of productivity growth, the faster poverty will decline. Simply put, the ticket out of poverty is higher productivity jobs.

Long-term trends in productivity growth have shown improvements in Latin America in the 1990's. According to the Inter-American Development Bank (IDB), the 1990's had higher productivity growth than the 1980's, reflecting economic reforms especially in the macroeconomic areas. Productivity growth was 0.7 percent per year in Latin America in the 1990's after averaging less than zero in the 1980's.

However, I am optimistic that productivity growth in Latin America could improve by a much greater amount. While productivity growth was 0.7 percent in Latin America in the 1990's, it was 1.7 percent in the developed countries and 2.7 percent in the East Asian countries. That 1 percent or 2 percent productivity difference would make a huge difference in living standards over time.

The first step to raising productivity growth is gaining an understanding of why productivity is so low. Productivity depends on two things: capital per worker and the level of technology. If there are no impediments to the flow and accumulation of capital and technology, then countries or areas that are behind in productivity should have a higher productivity growth rate. More and more evidence has been accumulating that there are significant impediments to investment and the adoption of technology that are holding countries and people back.

The United States is seeking to reduce these impediments to higher productivity growth by emphasizing the need for policy steps in three areas. As identified by President Bush these three areas are: ruling justly, investing in people, and encouraging economic freedom.

First, poor governance, the lack of rule of law or enforceable contracts, and the prevalence of corruption create disincentives to invest, to start up new firms, and to expand existing firms with high-productivity jobs. This has a negative impact on capital formation and entrepreneurial activity.

Second, weak education systems impede development of human capital. Workers without adequate education do not have the skills to take on high-productivity jobs or to adopt new technologies to increase the productivity of the jobs they do have. There is wide agreement that better education is key to productivity growth. Although the labor force in Latin America grew at similar rates as East Asia in the 1990's, the rate of educational improvement was slower during the past decade. There are, of course, important educational success stories. For example, in Brazil the *Bolsa Escola* program, which provides funds to families with low incomes whose children attend school, has led to higher enrollments.

Third, too many restrictions on economic transactions prevent people from trading goods and services or adopting new technologies. Lack of openness to trade, state monopolies, and excessive regulation are all examples of restrictions that reduce incentives for innovation and investment needed to boost productivity. For example, in Latin America on average it takes 12 legal and government administrative steps to start up a business. In Canada, it takes 2 steps to start up a business; in the United States it takes 4 steps.

Raising productivity rates involves steps to foster a stable macroeconomic environment, boost the skills of individual workers, and introduce market forces to help channel resources most effectively. In promoting these policies, however, we must remind ourselves that there is no shortcut to sustained economic growth and that good results require a patient commitment over a long period of time.

Achieving U.S. Policy Objectives

The United States is seeking to encourage increases in economic growth in Latin America through an array of concrete policy steps at the bilateral, regional, and multilateral levels.

President Bush signaled the U.S. commitment to bilateral efforts earlier this year when he proposed a dramatic increase in foreign aid through the Millennium Chal-

lenge Account initiative. Beginning in 2004, increased assistance will be available to strong performing countries—those that govern justly, invest in their own people, and create a favorable climate for private enterprise—with the total increase reaching $5 billion per year starting in 2006. These funds provide a powerful incentive for countries to create an environment conducive to growth.

The United States has also launched several country-specific initiatives, such as reform of the North American Development Bank (NADBank). President Bush has long recognized the need for serious reform of this institution. He and President Fox, who had also proposed reforms, decided to do something about the problem. The United States and Mexico established NADBank in 1993 for the purpose of helping border communities cope with the environmental pressures relating to the North American Free Trade Agreement in the United States-Mexico border region. But during its 7 years of operation, the overall performance of NADBank was unsatisfactory. NADBank had approved only $23.5 million and disbursed only $11 million in loans to projects, despite having $405 million in authorized paid-in capital and a total lending capacity of $2.7 billion.

We have made much progress in the reform effort. In order to better use the authorized funds at NADBank, the reforms called for increasing the amount of support from grants and low-interest rate loans, allowing NADBank projects to go deeper into Mexico, merging the boards of NADBank and its project-certification sister institution the Border Environmental Cooperation Commission, and allowing retained earnings to fund supply-side water conservation projects on both sides of the border. The reforms were negotiated last spring and summer. The needed legislation has passed the House and is pending in the Senate.

Another example of an initiative with Mexico is the Partnership for Prosperity—an initiative aimed at strengthening Mexico's economy through a number of measures to improve access to capital, build capacity, and stimulate private investment in areas that do not yet fully benefit from NAFTA.

One key area that could greatly facilitate the flow of capital to Latin American countries involves reducing the cost of remittances sent from abroad. The Inter-American Development Bank estimates that Latin Americans living in the United States send an average of $200 to their native countries an average of seven to eight times per year. These remittances surpassed $23 billion last year—about one fifth of total worldwide remittances—and represent an enormous resource transfer to families and businesses that can make direct use of the funds. Although remittance charges are declining, they still range from 6–15 percent of the remitted amount plus an exchange margin that ranges from 3–5 percent. Increased competition as more and more traditional financial institutions offer remittance products should help to lower costs.

Trade has enormous significance for spurring productivity gains and growth in the region. With approval of Trade Promotion Authority, we are strongly committed to rapid progress in reducing trade and investment barriers throughout the hemisphere. The Doha Agenda of global trade talks will give particular emphasis to promoting development. At the same time, the United States expects to sign a free trade agreement with Chile soon, will continue to work toward completion of the Free Trade Area of the Americas by 2005 as co-chair of the process with Brazil, and has announced the United States intention to begin negotiating a free trade agreement with Central American countries starting the first of this coming year.

The International Financial Institutions

At the World Bank and Inter-American Development Bank, the United States is supporting development projects and programs that address the basic causes of low productivity, including projects to raise health and education levels, increase access to clean water and sanitation, and improve the climate for private sector development. A key element of this strategy has been the successful U.S.-led effort to have the International Development Association (IDA) expand the amount of grant financing it provides to poorer countries in order to boost development prospects without adding to country debt burdens. We will also continue our efforts to have the multilateral development banks make operational a system to better measure, monitor, and manage for development results. Measuring development results figures prominently in the most recent IDA round in that the agreement's contribution structure allows donors to increase their funding levels if concrete measurable results are achieved. We are convinced that donors and developing countries will benefit from routinely quantifying development achievements and understanding the reasons for success and failure.

Within the IMF, the United States is working to strengthen mechanisms to detect potential crises early and act preemptively to address sources of vulnerability. We are also working to ensure that the IMF is effective in situations when a financial

crisis develops. The IMF is most effective when it focuses on the areas central its expertise: monetary, fiscal, exchange rate, financial sector, and debt management policies. At the same time, we are working to increase discipline in terms of access to IMF resources to reduce the size of IMF packages and thereby reduce the risk of moral hazard—for example, the belief that in a crisis, large-scale IMF assistance will protect investors from the consequences of their decisions. We have also refrained from providing longer-term bilateral loan assistance in crisis cases, as was done in the past. Emphasizing that the IMF must be the key source of emergency support and avoiding recourse to bilateral assistance allows the availability of IMF resources to act as a natural constraint on the size of official financing packages.

We have taken into account a number of considerations to assess when and whether the international financial institutions should provide support to countries, particularly in light of crises and other challenges in Latin America.

First, and most important, countries must be committed to implementing credible and sustainable economic policies. Such policies should embrace a number of principles: strong or improving fiscal accounts, incentives for private sector investment in order to promote growth, steps to strengthen financial systems, and sound monetary and exchange rate policies. Not all actions can be accomplished immediately, of course, but it is important to begin the process as a means of putting economies back onto a sustainable path, as a signal of the authorities' intentions, and as a first step toward re-establishing confidence.

Second, experience has shown that lending programs that lack strong ownership by a country's leaders are likely to fail; we should not support such programs. Narrowing the range of conditionality to critical issues helps increase country ownership over effective programs. And in the context of crisis lending, providing official sector support to countries with strong ownership over high-quality economic programs that promote economic growth is the best way to ensure that official sector interventions in time of crisis are laying the basis for a return to economic health over the long term.

Third, it is important for the IMF and for other institutions to structure international financial and development packages properly so that strong incentives for good policy performance are maintained. Prior actions that must be completed before a lending program begins, for instance, can sometimes be a useful means for a country to demonstrate its commitment before international funds are disbursed. "Backloading" the financial assistance, with smaller amounts of money provided initially and larger amounts provided later on, can help to ensure that a country's performance does not weaken over time. Lending conditions within a program should also be carefully targeted, focused on those issues that contributed to a crisis and addressing steps that are most essential for future success. Not every crisis results from a fiscal deficit, for instance, and so not every program should automatically require fiscal retrenchment.

Argentina, Brazil, and Uruguay

Let me provide an update on three of the key countries in the region that have received particular attention in recent months—Argentina, Brazil, and Uruguay.

Argentina has not yet reached a new agreement on an IMF program, but has recently made some progress in developing a short-term program to restore monetary stability. We hope that an agreement will be reached soon. Bush Administration officials, including Secretary O'Neill, have stated on numerous occasions both privately and publicly that we want Argentina to succeed. The United States has strongly supported efforts to provide Argentina breathing room as it works with the IMF to develop a sustainable economic plan. For example, the United States has backed four extensions this year of repayments to the IMF (totaling approxiamately $4.9 billion) and has also worked to accelerate lending from the World Bank and Inter-American Development Bank.

But finalizing an agreement between the IMF and Argentine Government has not happened quickly. The extensive economic problems Argentina has confronted—a dramatic reduction in output, debt default, extensive deposit and foreign exchange restrictions, provincial government deficits, and a sharp depreciation of the exchange rate—have required a significant amount of time and attention. Given the importance of Argentina's economy to the region and Argentina's need to get back on an economically sustainable path, we believe it is essential that Argentina's monetary and fiscal framework be strengthened as a basis for a new lending program. Encouragingly, in recent weeks, there have been some signs that parts of Argentina's economy have stabilized.

For Brazil, we strongly supported the August decision to provide an expanded IMF lending package given confidence in the current policy mix and the firm belief that the short-term liquidity pressures facing Brazil can be alleviated through con-

tinuing such policies. Furthermore, the design of the program "backloaded" the large majority of IMF resources so that much of the financing will be provided only if sound policies are maintained. The key policy conditionality underlying the program includes maintenance of fiscal prudence and concrete steps to reform major impediments to growth such as the current tax code. Comments by presidential candidates in recent weeks reaffirming support for the main pillars of the program increase the chances of its success.

In Uruguay, the United States supported a $3.8 billion official sector package, and drew on the Exchange Stabilization Fund to provide a short-term bridge loan until IFI financing could be put in place. We did so because Uruguay had a strong record of sound policies and we were convinced that the Uruguayan Government had a strategy to address its difficulties—particularly in the banking sector—and was committed to implementing that strategy.

While we do not yet know the final outcome, initial results in Uruguay have been encouraging. Since the IMF program was announced, we have seen increased stability in the financial system and continued strong performance by Uruguay. Under the IMF program, net deposits in the nonintervened banks have increased. As a result of this improvement in financial sector confidence, only one-third of the $1.5 billion in IMF resources targeted for the financial sector has been used. Uruguay still faces a difficult regional economic environment, but its leaders have shown their willingness to commit to necessary reforms and long-term economic goals.

Outlook for the Region

In spite of recent turbulence, I remain confident about the region's prospects. First, the current economic cycle of slow or negative growth will improve, especially as the U.S. economy continues to gain strength. At about 38 percent of GDP, exports comprise a large percentage of income for the Latin America region as a whole.

I believe that many countries within the region have made important progress over the past decade in strengthening the economic institutions and policies that will improve their growth prospects. In a number of countries, for instance, central banks have focused more on keeping inflation low. And many countries have abandoned soft exchange rate pegs and maintained floating exchange rate regimes, helping them to adjust more easily when faced with economic shocks. Others, such as El Salvador, have been successful with full dollarization.

Across the region, the private sector now contributes a larger percentage of GDP than it did during the 1980's, which will help Latin American economies regain their dynamism more quickly. Many countries now have more extensive trade and financial linkages amongst themselves and with developed economies—such as the United States and Europe—than they did in the past. This is a factor that will help to accelerate their recovery once conditions improve. Finally, Latin America also has a strong human capital and resource base that provides a solid underlying foundation for future growth.

PREPARED STATEMENT OF DANIEL K. TARULLO

PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

OCTOBER 16, 2002

Mr. Chairman, Senator Hagel, I appreciate your invitation to testify today. I am currently a Professor at Georgetown University Law Center. As you know, between 1993 and 1998, I held several economic policy positions in the Administration, ending as Assistant to the President for International Economic Policy. I testify today purely in my individual capacity as an academic, with no client interests or representation.

What Is At Stake

The importance of the topic of this hearing is difficult to overstate. If the world economy continues to stumble over the next year or two, much of South America may be afflicted with financial and business crises that produce another "lost decade," such as that which gripped the region in the wake of the debt crisis of the 1980's.

The human costs of that decade are incalculable in any meaningful sense. Yet out of that tragedy there did arise a renewed commitment in most countries of the region toward both democracy and market-oriented economic reform. By the time of the Summit of the Americas held in Miami in November 1994, most of the hemisphere looked forward to sustained economic growth. That confidence was shaken just a few weeks later by the onset of the Mexican financial crisis. In 1998, the

spread of the Asian financial crisis threatened to halt the progress that had been achieved. Today, Argentina is losing ground rapidly, and much of the rest of the continent is in danger of doing likewise.

The debt crisis of the 1980's helped convince Latin American countries to abandon the policies of the 1960's and 1970's that had laid the groundwork for crisis. Today, there is a growing sentiment in the region for abandoning the market-oriented policies of the 1990's that are blamed by many for the current difficulties. There is a real risk that countries in the region will fail to differentiate between specific policies that may indeed be tied to their financial problems, on the one hand, and a basic embrace of market economy policies on the other.

The consequences may be very serious. First, some countries could revert to import substitution and other failed policies of the past. This would be a prescription for economic stagnation. Second, if economic troubles persist long enough, democratic institutions may themselves become discredited, threatening the considerable progress of the last couple of decades. Third, because the market reforms of the last decade are widely characterized as part of the so-called "Washington Consensus," the United States may be blamed for the region's troubles. If so, prospects for true partnership with South American countries would be dashed. We might instead return to the bad old days of chronic mistrust and occasional confrontation.

Our interests and our values are thus very much at stake. We cannot solve Latin America's problems. But we can, and must, adopt an activist, supportive set of policies to reassure these countries that we stand behind them and to offer, at least, the outlines of a path to integration in the global economy that produces sustained and equitable growth.

The Origins of the Current Crises

The disheartening fact is that Argentina and Brazil, South America's two largest countries, are again in financial distress. Argentina, of course, has defaulted on its external sovereign debt. Its banking system has been dysfunctional for 10 months. The country is in severe recession, having suffered a double-digit drop in GDP over the last year. Brazil has, with the assistance of the International Monetary Fund, thus far contained the damage from the pressures on its currency and equity market in advance of the presidential election. But its position is tenuous, to say the least.

The origins and characteristics of the Argentine and Brazilian travails differ in many particulars. But it is important to note that the recent financial histories of these countries are closely intertwined. The Brazilian financial crisis of late 1998 and early 1999, itself an outgrowth of the Asian financial crisis, had a pronounced negative effect on the Argentine economy. Both nations have been seriously affected by lagging growth in European and North American export markets. And contrary to official expectations, Argentina's default on its external debt late last year has had contagion effects upon Brazil and other South American countries.

So too, longer-term developments in these countries bear important similarities. Each returned to democratic rule less than 20 years ago. Each implemented a managed currency regime in the early 1990's in successful efforts to vanquish runaway inflation. Each is struggling still to escape the tendency toward lax fiscal policy that has afflicted them for decades. Each implemented genuine market-oriented economic reforms in the 1990's, and took steps to strengthen their banking systems. But each still lacks some of the institutional capacity to support and regulate effectively a market economy.

There is considerable disagreement among official and unofficial observers as to the precise origins of the current crises. Indeed, the blame game is now being played with characteristic vigor by critics and defenders of the governments themselves, the IMF, and the U.S. Government. It seems to me that, while fair-minded people may disagree over the relative weights to be assigned, the chief proximate causes of both nations' problems are reasonably clear.

In Argentina, three factors stand out. *First,* the government ran significant budget deficits and thus incurred substantially greater debt during the 1990's. Much of this sovereign debt is denominated in dollars and much of it is owed to foreign lenders. Running budget deficits in bad economic times is generally good policy. But Argentina increased its total public debt to GDP ratios by more than a third during some of its best economic years, leaving it vulnerable to debt servicing problems during an economic downturn.

Second, the currency board that had been instituted a decade ago in a highly successful effort to tame inflation became a major source of distortions in the economy. This policy device, well-suited to inflationary times, is highly problematic during a recession. By tying the value of the peso to the dollar, Argentina's ability to increase export earnings was severely constrained during the extended period of dollar

strength. Argentine productivity was not keeping pace with American productivity growth, yet the relative prices of Argentine products remained valued as if this were the case. At the same time, the currency board made borrowing in dollars seem a bargain.

Third, the series of shocks that beset the world economy—particularly emerging markets—beginning in late 1997 exacerbated the problems created for Argentina by loose fiscal policy and the albatross of the currency board. Slowing United States and European economies meant less vigorous export markets for Argentina. Flows of long-term direct investment dried up. The 1998 Brazilian crisis and subsequent devaluation of the *real* struck another blow to the Argentine economy, with its fixed exchange rate.

By early 2001 many people—myself included—thought that the combination of Argentina's fiscal policy, currency board, and external debt position was unsustainable. By late 2001 nearly everyone, the IMF included, had reached the same conclusion. The default and devaluation of late 2001, while perhaps inescapable, left both the Argentine economy and political system in disarray. Only now, nearly a year later, do we see glimmers of hope that Argentina's problems may have bottomed out. Even if this proves to be the case, full recovery is a long ways away.

In several important respects, Brazil's situation is different and more favorable than that of Argentina. Brazil abandoned its managed exchange rate regime in early 1999 and has thus escaped in recent years the shackles of the strong dollar. Brazil has significantly reformed the fiscal relationship between state and federal governments that has so bedeviled Argentina. Indeed, Brazil has recently been running a primary budget surplus of between 3 percent and 4 percent of GDP (although its debt servicing costs are so high that it still has a substantial bottom-line budget deficit).

Unfortunately, Brazil's situation resembles that of Argentina in two important respects. *First,* Brazil's public sector debt rose dramatically during the 1990's. In fact, Brazil's public debt increased faster than Argentina's, nearly doubling during the decade, to about 60 percent of GDP. While this borrowing is less dollar-denominated and external than Argentina's, Brazil's external exposure is still sufficiently high (about 40 percent of total public debt) that it was vulnerable to changes in international capital market conditions and sentiment. *Second,* like Argentina, Brazil has been buffeted by the cumulative effects of South American economic problems and by uncertain prospects for global growth.

Finally, of course, the growing prospect of a change in Brazil's ruling coalition has, throughout the last several months, applied enormous pressure on Brazil's currency and equity markets. As Mr. Da Silva's election prospects brightened, culminating in his leading the vote-getting in the first round of elections, markets became edgier. Da Silva's commitment to significant social change and policy stances in earlier elections have unnerved some investors, notwithstanding his repeated commitments to honor Brazil's debt obligations.

The Role of the IMF

Consideration of the role of the IMF in the Argentine and Brazilian situations is perhaps best divided into discussion of: (1) the Fund's short-term decisions to provide or, eventually in the case of Argentina, not to provide assistance programs; and (2) medium-term issues concerning the wisdom of the Fund's advice to, and monitoring of, emerging markets.

Decisions on Stand-By Credits

The Fund's decision to provide a stand-by arrangement for Argentina in late 2000 was a questionable one, which has since been characterized by some from the outgoing Clinton Administration and the Fund itself as a close call one way or the other. It was difficult to see how Argentina's fiscal situation could feasibly and sensibly be reversed quickly enough to render its external debt obligations sustainable. Adding more multilateral debt seemed the triumph of hope over experience.

If the 2000 program was questionable, then the additional assistance program announced in the summer of 2001 was simply mistaken, as the Fund itself now essentially acknowledges. Renegotiation of Argentina's external debt, abandonment of the currency board, or both were clearly required. Perhaps a Fund package accompanying such measures would have had a chance of success, though one suspects it may have been too late to pull off a reasonably smooth landing. By the end of 2001, the Fund had reconsidered. It made no further assistance available to an Argentine government unable to meet its external debt payments and beset internally by rising popular anger.

The decision not to provide further assistance for the muddling-through efforts of the Argentine government is certainly defensible. What seems less defensible, at

least to an outside observer, was the apparent withdrawal of the Fund (and the United States) from the field. While Fund officials continued to make sympathetic noises about a willingness to help Argentina, it was hard to discern proactive efforts to assist in organizing a dialogue with creditors or in formulating a set of interim policy measures that would contain Argentina's downward slide and accelerate an economic turn-around. It may well be that the political situation in Argentina was by November 2001 so chaotic as to foreclose *any* coherent policy response by the government. If so, the mistake in having provided stopgap programs in late 2000 and mid-2001 is all the more telling.

In the case of Brazil, the Fund offered what I consider to be a very successful program for Brazil in December 1998. Indeed, in retrospect that program and Brazil's own economic management look to have been the turning point in the financial crisis that had started in Asia and was spreading to other regions. Brazil abandoned its exchange rate regime in the early stages of this program. As the 1998 stand-by arrangement was expiring, the Fund offered another program in September 2001, largely on the basis of unfavorable external developments. The Fund conditioned the program on achievement of primary surplus targets.

Late last summer the Fund reached the sound conclusion that investor uncertainty in advance of the presidential election could itself lead to financial crisis, regardless of the policies eventually followed by the new president. By announcing a program that had a large "headline" number but that withheld most of the assistance until after the new administration's policies become clear, the Fund was attempting a delicate balancing act. I agree with the Fund's effort to strike this balance and hope its formula succeeds.

My reservation about the program as announced was that it was unaccompanied by any formal private sector actions. If Brazilian policies, the world economy, and investor sentiment all break the right way, Brazil's situation may stabilize and its external debt may become sustainable. Given the size of that debt and the reality of a teetering world economy that may soon be shaken by major military conflict, I worry that debt rescheduling may be necessary. My own predisposition would have been to include some form of private sector involvement—such as commitments on net capital inflows in the medium term—in the initial plan, so as to enhance chances for its success. If restructuring becomes necessary in the coming months, further financial disruption is essentially inevitable.

The Fund's Advice and Expectations

It is very difficult for the Fund to escape criticism in the case of Argentina. The Fund has had multiple programs over several decades with the country. Moreover, as is now regularly pointed out, through much of the 1990's the Fund praised Argentina as an exemplar of privatization, market-oriented reform, and financial stability. Something was obviously wrong or missing in the Fund's prescriptions.

Yet it is important not to jump from this observation to the conclusion that every policy the Fund recommended was unsuitable or that its recommendations were the chief causes of the 2001 financial implosion. I should quickly note that I have certainly disagreed with Fund policies in the past, whether general or country specific. Up until quite recently, the Fund was on a campaign to eliminate all of the controls on capital inflows, with no more than nominal attention to the capacity of a country's financial system to absorb big inflow surges. The Fund's sometimes reflexive emphasis on fiscal tightening even in the midst of fiscal distress has often been inappropriate. Fund endorsement of privatization without regard to transitional and ownership arrangements can be ill-advised in some circumstances.

But privatization—whether well or poorly conceived—did not cause Argentina's financial crisis. And the Fund's response to Argentina's fiscal policy which is most susceptible to criticism is its *failure* to insist on more fiscal discipline during years in which economic performance was relatively good. Or, what amounts to a variation on this theme, perhaps the Fund should have pressed Argentina to limit its external sovereign borrowing. Likewise, the Fund might be criticized for not urging Argentina to abandon its currency board, since one of the principal lessons which the Fund drew from the Asian financial crisis is that a fixed exchange rate in an environment of free capital flows vastly increases the risk of financial crisis in emerging markets.

In assessing the Fund's dealings with Brazil, one might similarly criticize the Fund's acquiescence in the rapid increase in sovereign debt levels. Here, though, the criticism is less justified. In 1998, Brazil was a kind of firewall against the further spread of financial crisis. Insistence upon greater fiscal austerity in that period would have been counterproductive. Indeed, the Fund would have itself been subject to the recurring criticism that is pithily summed up in the witticism that IMF

stands for "It's Mostly Fiscal." By 2001, the Fund was conditioning a program on maintenance of a significant primary budget surplus.

Like Argentina in 2001, Brazil's exchange rate regime had helped create the conditions for crisis in 1998. Export earnings were artificially restrained by an overvalued currency, and short-term dollar debt was artificially attractive. Some have charged the IMF with the responsibility for Brazil's imposition of a crawling peg exchange rate in 1994. It may be fair to say that the IMF was once too tolerant of fixed exchange rate regimes—a position that it has now changed. But it does not accord with my understanding to say that the IMF urged a fixed-rate regime upon Brazil in 1994 (or, for that matter, upon Argentina in 1991). On the contrary, at least at the staff level there were serious misgivings about this policy step by Brazil.

What conclusions can we draw about the role of the Fund from the recent Argentine and Brazilian experiences? I believe these experiences reinforce one fundamental point and raise one fundamental question.

The fundamental point is that a presumption of private sector involvement should obtain whenever the IMF approves a sizeable stand-by credit to assist countries unable to service their sovereign debt. Usually the private sector involvement will be important for achieving a sustainable program for the country. Private sector involvement will always be important for creating a set of incentives for lenders and borrowers that are more closely correlated with the risks actually involved in specific debt transactions. The nature of the private sector involvement can and should vary with the particular circumstances of the debtor country. Sometimes commitments to maintain existing levels of exposure will be adequate. And sometimes rescheduling may be appropriate. Less frequently, some reduction in the debt stock itself may be necessary. But in all cases the private sector involvement must be real rather than specific. That means the development and publication of satisfactory, precisely-stated terms.

The fundamental question raised by the Argentine and Brazilian experiences is the degree to which we want the IMF to assume responsibility for the economic policies of emerging market countries with actual or potential debt problems. It should be clear from the preceding discussion that the rectification of possible IMF mistakes would have come only at the expense of substantial infringement on the sovereign decisions of a democratically elected government. Should IMF officials have pressured Brazil in 1994 not to adopt the pegged exchange rate? Should the Fund decide when a country should stop borrowing abroad? Should the trade-off between containing runaway inflation now and the risks of debt and currency imbalances later be made by the elected representatives of the people or by the Fund?

These are not easy questions. Uncorrected national policies may lead to requests for sizeable IMF stand-by credits. When a country is in crisis and seeking substantial international resources, some imposition of conditions is inescapable, as in any lender-borrower situation. Earlier reform would obviously be preferable. It is certainly incumbent upon the IMF to sound private and, in unusual circumstances, perhaps even public warnings about unsustainable national policies. How far the member states of the IMF want the Fund's staff to go in *forcing* policy decisions upon countries not in immediate crisis seems to me a subject in need of substantially more exploration and debate.

The Role of the Administration

It is apparent from the foregoing discussion that the situation in Argentina was already deeply troubled when the Administration took office in January 2001. The agenda for reforming the so-called international financial architecture had stalled. Quite frankly, the problems in the international financial system are not susceptible of quick and easy solutions, so one can hardly criticize the Administration for failing to solve those problems in less than 2 years. But, I regret to say, having been dealt a bad hand, the Administration has not played that hand particularly well.

The voice of a U.S. economic official is itself an important instrument of policy. A consistent, measured, and coherent voice establishes credibility, reassures market actors, and enhances U.S. economic leadership. The absence of such a voice has just the opposite set of consequences. While I think it unfair to hold the Administration responsible for all the financial problems faced by emerging markets, I think it is legitimate to criticize the lack of consistency, coherence, and restraint in its statements and actions.

When the Administration took office, it proclaimed the end of large IMF "bail outs." Although many were skeptical that such a blunt policy approach was optimal, it was certainly a clear position. The Administration's endorsement of a program for Turkey did not appear a real departure from this position, since most people understand that there is an implicit "security exception" to any stated international economic policy.

But the misguided program for Argentina and the defensible programs for Brazil and Uruguay have obviously undermined completely the Administration's stated policy position. The current Administration view appears to be that it will not support "unsustainable" IMF programs. I do not think one can find any Administration that has ever stated its support for unsustainable IMF programs. In the absence of a clearer policy statement, it is hard to know where exactly the Administration stands.

Similarly, with respect to reforms of the international financial system, just a few months ago the Administration publicly rejected IMF proposals for a sovereign debt restructuring mechanism (SDRM), in favor of voluntary terms in bond indentures. Again, one might agree or disagree with that position. Yet just a few months later the Administration appears to have endorsed the IMF plan. While one should always be mindful of Ralph Waldo Emerson's observation that "a foolish consistency is the hobgoblin of little minds," it is not reassuring to see the Administration walk away from a strongly stated position with no explanation of why its views had changed.

The relative passivity of the Administration during and after financial crises has also been disappointing. I understand and appreciate the Administration's view that it cannot impose solutions on Argentina or any other country. But it seems to me both ill-advised foreign policy and wasteful economics to have simply stood by and waited for Argentina to come up with an acceptable plan. Things are only made worse when Administration officials make off-handed comments critical of the country suffering through the crisis. The confusion and uncertainty attending a financial crisis afflict all participants. Generally speaking, an active role by the United States is necessary for expeditious movement along the path to a solution. There is a wide spectrum running between efforts to impose economic policies and sitting by the phone waiting for the Argentines to call. I would suggest that the better U.S. position is somewhere in the middle of that spectrum.

I am glad that the Administration has eschewed the simplistic solutions to complex financial problems that some have urged upon them. But the complexity and seriousness of problems require the exercise of leadership. While the U.S. agenda for international financial reform may have to be developed and implemented in stages, with continuing refinements, our direction and aims should be clearly stated and consistently advanced. The retreat of the United States from a clear leadership position on the problems of specific countries and on the broader issues of reform is costly as a matter of both foreign and economic policy.

Conclusion

At the risk of repetitiveness, let me end where I began. It is very much in the U.S. interest that the rest of this hemisphere consist of well-established democracies that produce equitable economic growth for their peoples. While there will always be good-faith differences of view as to the most appropriate U.S. policies in support of these ends, there can be little doubt that an active presence in attempts to solve national and regional problems is imperative. To me, this imperative means both a more visible presence in efforts to reverse Argentina's economic slide and a more consistent, active leadership role in efforts by the international community to address systemic international financial problems.

PREPARED STATEMENT OF MICHAEL MUSSA, Ph.D.

SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

OCTOBER 16, 2002

Thank you, Mr. Chairman and Members of the Subcommittee.

It is a pleasure to participate in this timely hearing concerning the difficult economic situation in Latin America and the efforts of the United States and the international community to ameliorate these difficulties.

This year, Latin America is suffering from its worst economic performance in nearly two decades, with real GDP for the region projected to drop by 2 percent—the largest decline since the darkest days of the debt crisis in 1983. Argentina is an economic catastrophe, with real GDP expected to fall a further 15 percent this year to roughly 25 percent below its 1998 peak. Uruguay is also in a severe and prolonged recession, facing a decline of another 8 to 10 percent in this year's output. Hit by domestic political turmoil, Venezuela's economy will probably shrink about 5 percent this year.

Other countries in the region are not faring as badly; but none are doing well. Brazil, which has the region's largest economy, will be lucky to achieve 1 percent

real economic growth this year—following upon 4 years where the average annual growth rate has been well below Brazil's potential. More importantly, Brazil now teeters on the brink of a major financial crisis that—if not averted—would push next year's growth sharply negative. Even the region's best consistent economic performer, Chile, faces another year of distinctly subpar growth. And Mexico, the region's second largest economy and the Latin American economy that has by far the most important economic linkages to the United States, will probably grow by less than 2 percent this year and remains at very significant risk if the U.S. economic recovery loses forward momentum. Thus, as general background for this hearing, it is relevant to recognize that the present economic situation in all of Latin America is not good, and there is considerable concern that it may not get much better anytime soon.

Of course, several important factors have contributed to Latin America's present economic difficulties and to the risks going forward, with the most relevant factors differing considerably across individual countries. The global economic slowdown and the weakening of many commodity prices have had a negative impact on exports from the entire region. Diminished inflows of direct foreign investment to Latin America have also partly reflected the weaker worldwide investment climate. Meanwhile, conditions in world financial markets have turned distinctly less hospitable toward emerging market borrowers—a factor of particular importance for relatively heavy indebted Latin American countries. And, negative spillovers within the region have also been important for some countries, most notably the severe negative consequences for Uruguay of the economic catastrophe in Argentina.

Despite the clear importance of such external factors, however, the most important causes of Latin America's present distress lie in domestic economic weaknesses and in how these weaknesses have interacted with adverse external developments. This is especially so in Argentina where (as I have argued elsewhere) the combination of a very rigid exchange rate regime and persistent imprudence in fiscal management ultimately led to a disastrous economic and financial crisis.[1] A similar story applies to Brazil's present predicament. A large build-up of net public debt (from 30 percent of GDP in 1994 to over 60 percent of GDP today) and a large external financing requirement (relative to merchandise exports) for the combined public and private sectors have made Brazil particularly vulnerable to an adverse change in financial market sentiment that now threatens to make sovereign default and/or systemic private default a self-fulfilling prophecy. Indeed, even for Uruguay where adverse external shocks have undoubtedly played a particularly large role in present difficulties, the high vulnerability to these adverse shocks was seriously exacerbated by the large prior build-up of public debt and the substantial foreign exchange risk exposure of Uruguay's financial system.

Clear recognition that Latin America's present difficulties and challenges reflect primarily domestic weaknesses and vulnerabilities that have been significantly exacerbated by adverse external developments is essential to understanding the particular issues that are the main focus of this hearing. The international economic and financial system does not function perfectly, and its malfunctioning is partly responsible for the instability now gripping much of Latin America. Confusion and inconsistency in the policies of the United States Government and of the official international community (particularly the International Monetary Fund) have, in my opinion, contributed to the malfunctioning of the system and, accordingly, have made the problems of Latin America somewhat more difficult than they might otherwise have been. Conversely, a more sensible and consistent set of policies of the international community to address potential and actual crises in emerging market countries—with credible leadership and support from the United States—could help Latin America emerge more rapidly and successfully from its present travails. Nevertheless, the principal tasks of managing the present difficulties, reducing the likelihood of their recurrence, and laying the foundation for a more prosperous future necessarily lie with Latin Americans themselves.

With this general principle in mind, I turn to address three specific issues raised in the letter of invitation to this hearing. First, what is my understanding and assessment of the United States Administration's policy concerning so-called "bailouts" of emerging market countries facing actual or potential financial crises, especially as how it relates to Uruguay and Brazil? Second, what is my evaluation of the approach that the IMF has taken in the cases of Uruguay and Brazil, in comparison with that adopted in the recent case of Argentina? Third, what should the

[1] See Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy,* Policy Analyses in International Economics, No. 67, Institute For International Economics, Washington, DC, July 2002.

international community attempt to do about problems of sovereign (or systemic) bankruptcy?

United States Policy Toward Large-Scale Official Support

Perhaps there is, somewhere, a very careful explanation of the present U.S. Administration's general policy toward official financial support for emerging market countries facing financial crises. Perhaps this statement somehow rationalizes the rhetoric which suggests that the policy is to oppose "large-scale bailouts" and the facts which show actual Administration support for official support packages on a scale and at a pace that dwarfs past efforts in this area. As a more than casual observer of these matters, however, I am befuddled by the glaring inconsistency between the Administration's words and actions; and I am far from the only one to suffer this confusion.

There has been little ambiguity about the Administration's rhetoric. In line with the analysis and recommendations of the majority of the Meltzer Commission, even before it took office, many of those who now hold positions of responsibility for economic policy in the present U.S. Administration voiced their opposition to "large-scale bailouts" of countries facing financial crises and of these countries' creditors. After a year and a half in office, the Administration's rhetoric on this issue has changed little—beyond the recognition that there may be "special cases" where large-scale official support may be appropriate and that new mechanisms for dealing with sovereign bankruptcies should be implemented or at least studied.

The facts, however, belie this rhetoric. Within barely 3 months of taking office, the Administration supported a large expansion (about $10 billion) of the already significant official support package for Turkey from the International Monetary Fund. This raised IMF support committed to Turkey to over 1,500 percent of its IMF quota, in comparison with a normal (cumulative) access limit of 300 percent of quota. Nine months later, after the tragedy of September 11 emphasized the geopolitical importance of Turkey, the Administration endorsed a further massive expansion of IMF support for Turkey (about another $12 billion). This raised IMF support committed to Turkey to about $31 billion or roughly 2,800 percent of Turkey's IMF quota. In absolute amount, as a ratio to IMF quota, and relative to Turkey's GDP (of about $200 billion), this was by far the largest amount of IMF support ever committed to a single country up to that time.

In August 2001, the Administration supported an $8 billion increase in IMF financing committed to Argentina, on top of the $20 billion of official support (from the IMF, World Bank, IDB, and the government of Spain) that had been committed in early January. This raised the ratio of official support committed to Argentina to GDP to a level that was, up to that time, exceeded only by the combined support committed by the U.S. Treasury and the IMF to Mexico in early 1995.

In September 2001, the Administration also participated in the IMF decision to extend about $15 billion in precautionary financial support to Brazil, in light of risks of contagion from the deepening crisis in Argentina. The committed IMF support, available for disbursement over a period of 15 months, amounted to 400 percent of Brazil's IMF quota, compared with a normal annual access limit of 100 percent of quota When, in the face of sharply deteriorating market sentiment, Brazil drew the bulk of this previously committed support in July 2002, Secretary O'Neill initially indicated strong United States opposition to any further IMF support for Brazil. This opposition, however, was soon reversed; and in August the United States Administration supported the commitment of an additional $30 billion of IMF support for Brazil, raising total committed IMF support to a new absolute record for a single country (but as a ratio to Brazil's GDP only about half that of Turkey).

For Uruguay, an IMF program with about $750 million of committed financing (about 200 percent of Uruguay's IMF quota spread over 2 years) was established in March 2002, succeeding an earlier program with about $200 of committed support. It soon became apparent, however, that this moderate level of support was woefully inadequate to meet a crisis involving massive withdrawals from Uruguay's banks and corresponding capital outflows. With strong encouragement from the United States Government, official support committed to Uruguay has now been raised to $3.8 billion or about 20 percent of Uruguay's GDP. This puts little Uruguay at the top of the league table—displacing Turkey—as the country with the highest ratio of committed official support to GDP.

It might reasonably be argued that geopolitical considerations, especially in the aftermath of September 11, make Turkey a special case that merits significantly larger official financial support than would normally be appropriate—just as geopolitical considerations plausibly argued for somewhat special treatment of Russia during the 1990's. However, it is difficult to see how important geopolitical considerations weigh in the case of Uruguay. More generally, with six cases during its first

20 months in office (Turkey in February 2001, Argentina in August 2001, Brazil in September 2001, Turkey again in February 2002, Uruguay in June and again in August 2002, and Brazil again in September 2002) in which the Administration has endorsed large international support packages for emerging market countries, it is nonsense to suggest that the Administration has a consistent policy of opposing such packages.[2] The Administration's rhetoric says something that its actions strongly contradict.

Has this inconsistency done real damage? I fear it has, in at least three ways.

First, officials in other countries have been confused and, in some cases, offended by the inconsistencies in U.S. rhetoric and actions. Quite rightly, many in Brazil (and many elsewhere in Latin America) took umbrage at Secretary O'Neill's remarks this summer criticizing official support for Brazil as a waste of the hard earned money of United States citizens to finance capital outflows from Brazil to Swiss bank accounts. Brazil has always repaid its official financial support—so that there is no reason to suggest that such support, whatever it might be used for, ultimately comes at the expense of United States citizens. Moreover, this summer Brazil was facing severe pressures on its currency because of capital outflows related to a general decline in market confidence. No doubt, this included capital outflows by Brazilian residents; but it also primarily reflected cutbacks in external credits to Brazil and a falloff in direct foreign investment into Brazil. In this situation, negative comments by the U.S. Treasury Secretary were certainly not helpful in restoring confidence—even if they were not a principal cause of Brazil's difficulties.

Second, for the international community to play a constructive role in dealing with emerging market financial crises, it needs to behave in a reasonably predictable manner and in accord with a reasonable set of principles and policies. This is essential for both the governments of emerging market countries and for the creditors of, and investors in, these countries (both foreign and domestic) to be able to function in a responsible and stabilizing manner. Obviously, circumstances will differ in individual cases, and no precise blueprint can be established for how all possible contingencies will be handled. Some amount of "constructive ambiguity" may also be useful. However, the international community needs to set reasonable rules of the game that can be understood by it various participants—or the already difficult problems of emerging market financial crises will be even more difficult. In this important area of international affairs, as in most others, constructive leadership from the U.S. Government is essential. Ideologically based policy rhetoric that is fundamentally and transparently contradicted by policy actions does not supply such leadership.

Third, actions speak louder than words; and judging by the Administration's actions, there is a relatively wide array of circumstances where large packages of international financial support (beyond the normal access limits of IMF support) need to be considered as part of the response to emerging market financial crises. In what circumstances should such support packages be considered? How should they be structured? When should they be augmented? When should they be terminated? These are critical questions of judgment that the international community needs to be able to address. And the answers to these questions that are stated as the policy of the international community need to be reflected in the actions taken in individual cases; and conversely. This point was emphasized by Peter Costello, the Treasurer (Finance Minister) of Australia in his remarks to the September 28 meeting of the IMF's International Monetary and Financial Committee:

> ". . . what counts is what the Fund actually does rather than what it says it will do. Ultimately, it is the quality of the judgments that are taken in each case and whether the frameworks are applied consistently, which will determine whether the Fund is successful in helping to resolve crises. In effect, each decision will be part of the ongoing process of defining the role and success of the Fund. It is important that its actions are consistent with its stated intentions. This has not always been the case."

Indeed, I believe that this is part of the explanation of what went wrong in the misguided decision to expand IMF support to Argentina in August 2001—a decision that I have characterized as the worst single mistake of the IMF during the past

[2] In large support packages, there has been greater reliance on IMF's financing and less reliance on bilateral official financing than before 2001. In particular, there has been nothing similar to the $20 billion of bilateral official support that the United States Treasury extended to Mexico in 1995–1996. Nevertheless, looking at total commitments of official support (excluding the phony commitments in the so-called second lines of defense), the scale of recent commitments of official support, relative to any relevant standard, has been larger recently than in the past.

decade. In December 2000, the IMF agreed, with the full participation of the outgoing United States Administration, to a large international aid package for Argentina in order to provide the Argentine authorities with one last opportunity to avoid sovereign default and a disastrous economic and financial crisis. Everyone knew that there was significant risk that this effort might not succeed, especially if the Argentine authorities failed to carry through on their commitments to achieve moderate additional fiscal consolidation. But to those who saw large support packages as appropriate in some circumstances, the risks seem to be worth it, especially in view of the alternative.

With earlier large support packages, there had also been significant risks of failure, and some actual failures. Allowance for this possibility was made in how the packages were designed and/or implemented. In Mexico, in early 1995, the policies of the Mexican authorities initially proved inadequate to halt a collapse of confidence and catastrophic depreciation of the peso. Appropriate strengthening of these policies, backed by continued commitment of large-scale international support, was essential to achieve success. In Korea in December 1997, a rapid run-off of international bank credits threatened to overwhelm the government's modest reserves and available official financing, thereby forcing a catastrophic financial collapse. Facing up to this challenge, on Christmas eve, the policy strategy was changed; the major industrial countries moved to encourage their commercial banks to roll over their Korean exposures, with the backing of guarantees from the Korean government. The new strategy stemmed reserve losses and helped to reestablish stability. In Russia in the summer of 1998, the size of the initial IMF disbursement in a large official support package was cut back when the Duma failed to pass key legislation required under the IMF program, and the support package lapsed after the first disbursement when the Russian authorities defaulted and devalued. In Brazil in the autumn of 1998, a large official support package backed a stabilization program that, at the insistence of the Brazilian authorities, sought to preserve that country's crawling peg exchange rate regime. In view of substantial doubts about the viability of that exchange rate regime, however, the support package did not permit unlimited use of these resources to defend the exchange rate. When the policies of the Brazilian authorities proved inadequate to sustain market confidence, the exchange rate regime collapsed. As a condition for continued official support, Brazil then had to move to a floating exchange rate regime. Thus, in all of these cases where large support packages were used, the possibility of failure was recognized (at least implicitly), and approaches to deal with this possibility were considered and implemented.

In Argentina by the summer of 2001, it was clear that the stabilization effort was failing and there was no reasonable expectation that the Argentine authorities could implement policies to correct the situation. Without commitment of additional official support of at least $30 billion—something that the official community was not prepared to contemplate—sovereign default and collapse of Argentina's convertibility plan had become unavoidable. Understandably, the Argentine authorities were loath to recognize this fact. But the leaders of the international community (at the IMF and in key finance ministries) should have known better. Augmenting the support package for Argentina and disbursing another $6 billion of IMF financing in early September 2001 was a stupidity. The collapse was merely postponed by a few weeks, Argentina was stuck with $6 billion more of official debt that it now finds very difficult to repay or reschedule, and potential opportunity to manage the inevitable collapse in a less catastrophic manner was lost.

To what extent did general disdain of senior U.S. officials for large official support packages contribute to the serious mismanagement of this particular support package. It is difficult to know, especially because relatively limited practical inexperience with these issues probably also played a role. However, common sense suggests that those who are ideologically opposed to large international support packages are probably not very well prepared to manage them effectively. By analogy, while we do not want war mongers as our military leaders, a conscientious objector is not suitable as Commandant of the Marine Corps. If the United States endorses an international system that uses large packages of official support as part of the mechanism for dealing with emerging market financial crises—as is implied by the actions of successive U.S. Administrations—then the responsible U.S. officials need to understand and appreciate both the uses and the limitations of this tool of international economic policy.

Uruguay and Brazil

Uruguay is a small country with a GDP of only about $20 billion, less than a one-tenth of the size of the Argentine economy and barely 3 percent of the size of the

Brazilian economy.[3] Because of its small size, I normally do not pay much attention to Uruguay. However, because of Uruguay's close economic linkages to Argentina (and to a lesser extent to Brazil), it was clear even to me that Uruguay was in for serious trouble (on top of an already ongoing recession) as Argentina's crisis deepened over the course of last year. This judgment was clearly shared by most of the relevant staff at the IMF. The report for the annual Article IV consultation with Uruguay (dated September 21, 2001) emphasizes that ". . . Uruguay is *highly vulnerable* to further shocks in the region." [Emphasis in original.] Nevertheless, nothing special was done last year to help Uruguay contend with the adverse spillovers that were obviously likely to come from Argentina, other than continuing with a modest IMF program (with support of about $200 million or about 50 percent of Uruguay's IMF quota spread over 22 months) that had been established in May 2000.

With the existing IMF program due to expire at end March 2002, negotiations for a new program were underway during the winter of 2002. They concluded with an agreement (approved by the IMF Executive Board on March 25, 2002) that committed about $750 million of IMF support spread over 2 years. This amount was almost at the upper limit of normal access for Uruguay to IMF resources. Nevertheless, I believe that the technical staff at the IMF understood from the start that this new program fell far short of what was likely to be needed to help Uruguay successfully confront its impending crisis—mainly but not exclusively the result of contagion from Argentina. Whatever might have been the views of the technical staff, however, the management of the Fund and the Fund's major shareholders were not, at this point, willing to contemplate yet another IMF program beyond the normal access limits.

A special characteristic of Uruguay is that it has a large banking system relative to the size of its economy, with assets of public and private banks amounting to about 50 percent of GDP. Most of the liabilities of the banking system are denominated in or indexed to the U.S. dollar, and a substantial part of bank deposits are held by nonresidents (mainly Argentines). Banks maintain large foreign-exchange assets to offset their foreign-exchange liabilities, but are nevertheless exposed to considerable risk from sharp depreciation of the peso against the dollar. Uruguay also has a substantial public debt, and the ratio of public debt to GDP has risen rapidly since 1998 as the economy has been in recession and the government's fiscal position has deteriorated. The decision to double (to 15 percent per year) the rate of depreciation of the peso against the dollar in June 2001 was necessary in view of the deterioration in Uruguay's internal and external economic situation; but, as a portent of troubles to come, this did not ease concerns about the banking system or the rising public debt ratio.

In spring 2002, the problems latent in Uruguay's economic and financial situation began to deepen. Large outflows of bank deposits, including substantial outflows by nonresidents, put downward pressure on the exchange rate and rapidly ate into both the liquid foreign assets held by public and private banks and the central bank's foreign currency reserves. Facing huge reserve losses it soon became necessary to allow the peso to float (for example, sink) against the dollar. By late May, a new IMF mission was on its way to Uruguay with the announced intention of negotiating a substantial augmentation of IMF support. In mid-June, Deputy Managing Director Eduardo Aninat announced that IMF management would endorse an increase of IMF support for Uruguay of about $1.5 billion—bringing total committed IMF support to over 600 percent of Uruguay's IMF quota, more than double the normal cumulative access limit.

As most of the technical analysts suspected, even this large new commitment of IMF support was not enough to contain Uruguay's deepening crisis. In early August, IMF Managing Director Horst Kohler announced a further augmentation of IMF support committed to Uruguay—this time, about another $500 million. The World Bank and the Inter-American Development Bank (IDB) would also chip in increases in their support, bringing total official support committed to Uruguay to $3.8 billion, or roughly one-fifth of Uruguay's GDP.

[3] Large fluctuations of exchange rates over relatively short time periods can change dramatically the dollar value of the GDP of emerging market countries. In the medium term, however, real exchange rates (for example, exchange rates adjusted for movements in national price levels) are relatively stable. The dollar values of countries' GDP's referred to in this statement reflect what the GDP is at normal values of exchange rates when the economy is operating near its potential. For Argentina, GDP is about $250 billion, for Brazil it is about $600 billion, for Uruguay it is about $20 billion, and for Turkey, it is about $200 billion. In comparison, U.S. GDP is about $10 trillion.

However, even at this stage, it is still unclear whether the large amount of official support will be enough to enable Uruguay to resolve its financial difficulties without a restructuring either of its public debt or of the assets and liabilities of most of its banking system. Indeed, despite repeated augmentations of its financial support, the international community has never really faced up to the fundamental questions of whether, and under what policies and conditions, Uruguay can successfully emerge from its present crisis without a comprehensive debt restructuring, or whether a comprehensive debt restructuring is not, in fact, an essential part of the solution of Uruguay's difficulties. Rather, the strategy seems to have been to throw more and more money at the problem in the hope that it will go away—perhaps with the recognition that what is a lot of money for Uruguay is not all that much from the perspective of the international community.

In summary, my view is that the performance of the international community in its efforts to assist Uruguay during the past 9 months fell considerably short of the best that one might reasonably have expected. Tiny Uruguay was facing a major potential financial crisis—mainly reflecting contagion from Argentina. From the start, it was clear that moderate levels of official support, within normal access limits, would clearly not be adequate to forestall the crisis. Only massive official support or a very painful restructuring of Uruguay's public debt and financing system would do the job. The international community, however, was not prepared to face up to this choice. It dithered. As the crisis deepened, significant official support was pledged, but not enough to be entirely convincing. The result has been that large-scale support that might have been sufficient to resolve the problem if fully committed at the start has instead still left significant risk of further troubles. Moreover, even with a record ratio of official support to GDP, it is still unclear whether the strategy will work for Uruguay, or whether a resolution involving comprehensive debt restructuring might be either better than what has been done and/or still necessary.

In the case of Brazil, I believe that the performance of the international community has been much better, notwithstanding important mistakes by the U.S. authorities. Recognizing that Brazil might suffer adverse spillover effects from Argentina's crisis, a precautionary IMF program was established in September 2001. Under this program, Brazil progressively accumulated the right to draw up to about $15 billion of IMF resources, under the condition that it maintain a responsible fiscal policy (with a primary budget surplus of at least 3½ percent of GDP). The objective was to reinforce confidence in Brazil's economic policies both by supplying an important supplement to Brazil's own foreign exchange reserves (of $30 billion to $40 billion) and by providing the monitoring of an IMF program to help assure that critical economic policies remained on track.

Nevertheless, there clearly remained a significant risk that a financial crisis might beset Brazil. To demonstrate that this risk was anticipated, not merely recognized in hindsight, I quote from my *International Economics Policy Brief* on "Prospects for the World Economy: From Global Recession to Global Recovery," released as PB02–02 by the Institute for International Economics in early April 2002.

> "The major question for Latin America (aside from the uncertainties about Argentina) is the likely performance of the Brazilian economy—which accounts for 40 percent of Latin America's GDP. . . . The key question for Brazil is whether growth will reaccelerate as global growth recovers, or whether uncertainties arising from the October elections and spillovers from Argrentina may provoke a crisis of confidence in the sustainability of Brazil's debt dynamics, leading to another economic downturn.
>
> "The fact is that, for an emerging-market country, Brazil has a relatively high ratio of public debt to GDP. Most of this debt is either quite short-term, has floating interest rates that adjust rapidly to movements in short-term market rates, is denominated in foreign currency, or has some combination of these features. This implies that if for any reason (including rising doubts about Brazil's ability to meet its debt service obligations), interest rates on Brazilian debt rise or the foreign exchange value of the *real* [Brazil's currency] falls, Brazil's debt service burden and/or the ratio of debt to GDP will rise—contributing to worries that debt dynamics may be unsustainable. Moreover, Brazil has a relatively small share of exports in GDP and, accordingly, is dependent on a continuing inflow of foreign capital to finance a significant current account deficit and also to finance a continuing rollover of substantial foreign indebtedness. Thus, apart from possible concerns about the stability of public sector debt dynamics, there are also potential concerns about the financing of Brazil's external payments.

> If confidence is lost in either of these key areas, a crisis would likely ensue . . .
>
> "As an optimist, I assume that the chances are three to one that Brazil will navigate through the difficulties of 2002 without a crisis . . ."

Unfortunately, this optimism was short lived. During May, opinion polls began to show a significant lead for the Worker's Party presidential candidate, Luis Ignacio Lula da Silva (Lula) and relatively weak support for the candidate of the ruling coalition, Jose Serra. This provided a trigger for increased market concerns about what might happen in Brazil after the election. The interest rate spread on Brazilian Brady bonds, which had stood at about 700 basis points above U.S. Treasuries in early April, began to rise and breached 1,000 basis points in June. The *real* came under downward pressure as foreign creditors began to cut back their Brazilian exposures and Brazilians scrambled for foreign exchange to meet debt service obligations and pay for the trade deficit.

During the summer, as Lula's poll results remained strong and Serra's results generally weakened, the crisis deepened, with interest rate spreads widening to 2,000 basis points and with the *real* sinking to well beyond 3 to the dollar (versus about 2.3 to the dollar at the start of the year). While shifting poll results clearly influenced these developments, the true underlying cause was the vulnerability in Brazil's public debt and external payments positions and the problem of "multiple equilibrium" that these vulnerabilities generated. John Williamson, my colleague at the IIE presents a very useful and insightful analysis of this problem in his *International Economic Policy Brief,* "Is Brazil Next?" issued as PB02–07 by the Institute for International Economics in August.

Under the general assumption that the Brazilian government continues to run a responsible fiscal policy with a primary budget surplus of 3½ to 4 percent of GDP, there are two possible outcomes for Brazil's public debt dynamics: stable and unstable. If people believe that the debt dynamics are stable, then the holders of Brazilian government debt (both domestic and foreign) will probably be satisfied with real interest rates on this debt 7 to 8 percent. These would be very high real interest rates for an industrial country like the United States, but in line with what real interest rates have been in Brazil and in many other emerging market countries. At this level of real interest rates, experience suggests that the Brazilian economy can grow in line with its potential—a real GDP growth rate of perhaps 4 percent. In this situation, starting with a public debt to GDP ratio of 60 percent, a primary budget surplus of 3½ to 4 percent of GDP would be sufficient to put the debt to GDP ratio on a downward path. Thus, confidence that public debt dynamics are sustainable leads to the result that they will be sustainable.

On the other hand, if people believe that the Brazilian government cannot successfully manage its finances without restructuring the public debt, they will demand high real interest rates to compensate for the risk of the losses they will take in the event of a restructuring. At a real interest rate of 10 percent, with a debt to GDP ratio of 60 percent and a real GDP growth rate of 4 percent, it takes a primary budget surplus of 4 percent of GDP just to stabilize the debt to GDP ratio. At real interest rates above 10 percent, public debt dynamics are unstable (without an increase in the primary budget surplus). Higher real interest rates also reduce the likely growth rate of the Brazilian economy which worsens prospects for debt sustainability. Most importantly, by making debt sustainability less likely, higher real interest rates promote even higher real interest rates in a vicious cycle. At present, interest rate spreads on Brazil's external foreign currency debt imply real interest rates above 20 percent.[4] There is no doubt that these interest rates embody a very substantial premium for the risk that the Brazilian government may have to restructure its debt. If in coming months confidence is not somehow restored and interest rates are brought well down from present levels, debt restructuring will become a self-fulfilling prophecy.

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[4] Real interest rates on Brazil's internal debt are significantly less than 20 percent. In particular, about half of the domestic debt is denominated in domestic currency and bears interest at a rate directly linked to the interbank overnight rate, the Selic rate. The Central Bank has been holding the Selic rate at 18 percent. With inflation now running at least 5 percent and probably headed upward, the real interest rate on the Selic linked domestic debt is in the range of 10 to 12 percent. But, without the imposition and effective implementation of stringent capital controls, the Central Bank will not be able to keep the Selic rate down at 18 percent if market interest rate spreads on Brazil's external dollar-denominated debt remain above 20 percent or even 15 percent. Indeed, the Brazilian government is already encountering difficulty in the auctions in which is seeks to roll over its (relatively short-maturity) Selic-linked debt. Eventually, if market determined real interest rates on Brazil's external debt remain very high, domestic real interest rate will rise to meet them.

Of course, the preferred outcome from this multiple equilibrium situation would be for confidence in debt sustainability to produce that result (assuming that the Brazilian government continues to deliver a very responsible fiscal policy. John Williamson and many others argue that this is the economically appropriate solution that the market should either naturally seek this solution or be pushed toward it. While I appreciate this position, I also tend to share the skepticism of one of my other IIE colleagues, Morris Goldstein.[5] While sometimes fickle, the market is not completely nuts. After several years of large private capital inflows and official acclaim for its economic policies, Argentina has recently defaulted on a large volume of public debt. The situation in Brazil is in some respects (relatively high public debt and a high ratio of external liabilities to exports) similar to that in Argentina. And despite recent official praise for Brazil's sound policies, the policy track record is not entirely reassuring.

In particular, during the 8-year tenure of President Cardoso, the net public debt to GDP ratio has risen from 30 percent to over 60 percent. In addition, the government has spent large privatization revenues. Part of the increase in net public debt is explained by the recognition of previous off-the-books losses or "skeletons" and, especially recently, by the sharp increase in the domestic burden of dollar-denominated or dollar-linked debt arising from the large depreciation of the *real.* But not yet all of the skeletons have emerged; and the choice that the Brazilian government made to issue dollar-linked debt clearly involved substantial contingent liabilities that are now being manifest at a particularly embarrassing time. Thus, in Brazil, the market knows that it has something to worry about, and sweet talk is not going to be enough to persuade it otherwise.

What has the international community done to help Brazil in its deepening predicament? Having met the conditions for its September 2001 IMF program, in July, Brazil exercised its accumulated rights to draw on IMF resources to the tune of about $14 billion. More importantly, the IMF agreed to a new stand-by arrangement (formally approved and announced on September 6, 2002) that committed about an additional $30 billion of IMF support to Brazil, subsequently supplemented by additional commitments from the World Bank and the IDB. The new IMF program provided only an additional $3 billion immediately and committed another $3 billion for potential disbursement before year end; and it reserved the remaining $24 billion for potential disbursement during 2003, conditional on the new Brazilian government maintaining responsible fiscal and monetary policies. The objective of the new IMF program was two fold: to provide Brazil with some additional resources to help meet near-term market pressures (mainly by allowing Brazil to utilize an additional $10 billion of its own foreign exchange reserves); and to help restore market confidence by assuring significant additional IMF support based on continued sound policies.

Market reaction to the initial announcement of the new IMF program (in August) was positive, but this lasted for barely a day. Markets soon figured out that the new program had not significantly altered the fundamentals of Brazil's economic and financial situation nor the uncertainties associated with the upcoming election.

Nevertheless, I believe that this new program was the right approach in the circumstances. Unlike Argentina by the summer of 2001, the situation in Brazil is not (yet) hopeless; and comprehensive restructuring of Brazil's public debt and probably most of its private debt is not (yet) inevitable. The Brazilian elections (which will necessarily bring a change of government), however, are a critical barrier to taking the key decisions about what strategy to adopt to deal with Brazil's present predicament. The present Brazilian government is unwilling to contemplate debt restructuring because it sees it as unnecessary and highly destructive, and probably also because it realizes that restructuring would signal the failure of the policies of the past 8 years. On the other hand, the present Brazilian government cannot credibly commit to policies that will remove the risk of restructuring; the responsibility for the design and implementation of such policies belongs to the next Brazilian government. That new government will not be determined until the elections are finished. Before the elections, no sensible candidate wants to contemplate and certainly not talk about the possibility of a debt restructuring. And it is very difficult to be specific and credible concerning policies that may be needed to avoid restructuring when no one even wants to admit that such a terrible thing is possible.

In this situation, delay of critical decisions until after the Brazilian elections has been the only available and desirable option—even if such delay came at the cost

[5] Mr. Goldstein's analysis of Brazil's situation and the likely need for a comprehensive debt restructuring were presented in a public lecture, "Is a Debt Crisis Looming in Brazil," at the Institute for International Economics on June 22, 2002. The main points are summarized in an op-ed column, "Brazil's unwatched borrowing," in the *Financial Times,* August 29, 2002.

of a few more billions of Brazil's dwindling foreign exchange reserves and some further shortening to the maturity of the government's debt. Once the elections are over, however, critical decisions will soon need to be made. In view of the calendar for debt refinancing, this cannot wait until the start of the 2003 when the new Brazilian government formally takes power. Key members of the new economic team will need to be designated before mid-November. The new government-to-be will urgently need to begin to make clear the main elements of its policy approach, and will also need to begin to build political support to enact and implement the needed policies—as it prepares to assume office. The first few months in office then will become critical for establishing whether the new government will be successful in putting its policies in place and what, under these policies, Brazil's economic future will look like.

What are the relevant policy strategies for the new Brazilian government and what role should the international community play in supporting them? I believe that there are two distinct policy strategies worth considering, with the middle ground between being essentially untenable.

Unfortunately, the untenable middle ground appears to be what is intended in the most recent IMF program for Brazil. As I understand it, this program envisions a respectable policy effort that would keep the primary budget surplus at just below 4 percent of GDP and maintain a monetary policy targeted at keeping inflation in the low single digits. There would be no effort to press the private sector, inside or outside of Brazil, to do anything special to support the stabilization effort. Official support would amount to the sums already committed by the IMF, World Bank, and IDB. The problem is that the situation in one where restoring market confidence is the critical issue. The market is already well aware of existing IMF program, and the market clearly judges it to be inadequate—not just marginally inadequate, but very substantially inadequate. While it is possible that, after the elections, for some unforeseeable reason, there would be a large spontaneous recovery of market confidence, it seems foolhardy to base Brazil's economic strategy on this thin hope. The result is likely to be that after another $10 billion to $25 billion of official support is disbursed to Brazil and frittered away in vain efforts to avoid default, the collapse will come. Then, in a disorderly way, virtually denuded of reserves and of international support, Brazil will undertake a messier-than-necessary debt restructuring. Probably it will not be quite as bad; but it will look much like Argentina all over again.

On one side of this untenable middle ground is a basic policy strategy that recognizes that, because of highly negative market sentiment and limited ability of the Brazilian government and the international community to act sufficiently forcefully to substantially improve this sentiment, comprehensive debt restructuring is practically unavoidable. The effort would then be to manage this restructuring with as little damage as possible. This would be no easy task. The comprehensive debt restructuring would necessarily include both the Brazilian government's external and internal debt. In addition, the assets and liabilities of Brazil's financial system would probably need to be restructured, as would most of Brazil's private external debt. To accomplish all of this without profound damage to the Brazilian economy, as well as to its Brazil's domestic and external creditors—as has happened in Argentina, would be a daunting task.

To complete this task with minimum unnecessary damage to all concerned will require continued sound fiscal and monetary policies. Use of already committed official financial support would also be important—but to help smooth out the inevitable difficulties of comprehensive debt restructuring, rather than blow it away in further futile efforts to delay a necessary restructuring. The result would probably still be a sharp negative shock to the economy (and to the government's public support); but if handled constructively, a comprehensive debt restructuring need not necessarily lead to a disaster of the magnitude of Argentina.

The other viable policy strategy is to adopt a vigorous, all-fronts effort to create a situation where comprehensive debt restructuring is not needed and clearly perceived as not needed. In my view, *at a minimum,* this requires that the Brazilian government credibly commit to fiscal policies that will raise the primary budget surplus to *at least* 5 percent of GDP (under reasonable economic assumptions) and maintain the surplus at this level at least until the debt to GDP ratio declines below 55 percent. A primary surplus of at least 4 percent of GDP should be maintained at least until the debt to GDP ratio declines below 50 percent. [The first objective could be met quite rapidly if the strategy is credible and appreciation of the *real* reduces the domestic currency value of Brazil's dollar and dollar-linked debt.] The policy strategy should also include responsible measures to persuade Brazilians both that they should be satisfied with reasonable real interest rates on the large volume of domestically held Brazilian government debt and that they should refrain from

large-scale capital flight. Brazil's foreign creditors should also be officially encouraged—in their own self-interest and as their essential contribution to an ambitious stabilization effort—to behave responsibly in maintaining and restoring their credit exposures to creditworthy customers. For its part, the official international community should pledge its continued financial support to Brazil—at a higher level than has already been committed, and clearly conditioned on stronger policy commitments from the Brazilian authorities and with some meaningful measures to assure constructive behavior by the private sector inside and outside Brazil.

How much additional official support might be contemplated? For a truly strong and credible stabilization effort with a good chance of success, it does not pay to be chintzy. Official support committed to Uruguay (which may not be enough) is at 20 percent of GDP. If official support for Turkey is augmented again next year (as I think likely), that too will rise to about 20 percent of GDP. For Brazil, official support at the level of 20 percent of GDP would amount to about $120 billion, somewhat more than double the substantial amount that has already been committed to Brazil. This sounds like—and is—a very large amount of money, reflecting the fact that Brazil has a large economy. Arguably a more modest commitment of official support, around $100 billion would be enough. However, in the business of large-scale official support packages, a key point to remember is that moderately large packages backing moderately strong programs tend to result in moderately large disbursements and program failures. Large support packages backing very strong programs are often not fully disbursed and generally lead to success. As General MacArthur observed about war, in the large package business, "There is no substitute for victory."

To be clear, I do not advocate war as the solution to all political differences among nations. Nor do I advocate large official financing packages as the answer to all potential and actual emerging market financial crises—including the crisis presently unfolding in Brazil. I raise the possibility of increasing official support for Brazil to the range of $100 billion to $120 billion primarily to dramatize a key point—directly relevant to the issues posed for this hearing. Consider the established policy, backed by the implicitly present U.S. Administration in the actions recently taken in the cases of a small country, Uruguay, and a moderately large country, Turkey. Apply this same policy consistently to a very large emerging market country, Brazil. What do you get? A package of international support that is truly enormous!

Would it be a good idea to proceed with such an enormous support package for Brazil? Even someone who believes, as I do, that large international support packages are appropriate in some circumstances would be compelled to say, "Better think long and hard before doing that one."[6] The general point is that similar careful thought should go into all cases where the potential scale of official support, relative to the size of the country, is quite large. The merits in all of these cases need to be weighed carefully because they set the policy of the international community. The approach adopted for a small country where large official support relative to the size of the country is comparatively modest in absolute terms sets a precedent for the approach that should be followed, in principle, for a much larger country where the absolute scale of official support could be enormous.

Consistent with the general policies that I believe should apply in such cases, I would recommend that commitment of substantial additional assistance to Brazil (or disbursement of much of the remainder of what has already been committed) should be undertaken only under tight conditionality. Specifically, the new Brazilian government must prepared to commit to policies that raise substantially the likelihood that comprehensive debt restructuring can be avoided. The acid test that these policies be sufficiently forceful that they go a considerable distance toward restoring confidence in financial markets to a degree that induces a large reduction of interest rates without which fiscal sustainability is impossible.

It is far from clear that the new Brazilian government will want to, or be able to, undertake such policies. This would surely require backing off from key campaign pledges like hikes in minimum wages and large new public investment programs. It would require measures to cut public spending and/or raise revenues that would undoubtedly face fierce political opposition. But the only other viable strategy—which will lead sooner or later to comprehensive debt restructuring—is also

[6] IMF resources alone are probably not adequate to finance commitments of another $40 billion to $60 billion to Brazil. Even for the IMF's contribution, it would probably be necessary to activate the New Agreements to Borrow (NAB) under which the IMF can borrow additional resources from key members. Also, official bilateral contribution would probably be needed to finance a large augmentation of the package for Brazil. All of this, hopefully, would help to focus the minds of those who control the IMF on what they are trying to do and on the appropriate means for accomplishing it. The IMF should not shield high officials from their responsibility.

surely no bed of roses. The new Brazilian government will have to make some very tough choices—and quite quickly. Only if the government decides to pursue policies that provide the essential basis for a strategy that avoids comprehensive debt restructuring should the international community entertain the possibility of supporting this strategy with commitments of significant additional support. Brazil must not be another case, like Argentina, where large official support is disbursed and frittered away because the officials of the country and the officials of the IMF and its leading shareholders are not prepared to face up to reality and to their responsibilities.

Moreover, the international community, and especially the IMF, really cannot afford a big failure in Brazil. After the crises in Asia and Russia and the debacle in Argentina, the credibility of, and public support for, the IMF have been seriously damaged. Institutional recovery after another big failure would probably be very difficult.

Indeed, the IMF's own finances are a growing matter of concern. For many years, there have been a few countries that have fallen into prolonged arrears on their obligations to the IMF. But the total amount of these arrears has remained relatively small. Now in the aftermath of the Asian crisis, Indonesia is in a situation where it has a large amount of IMF credit (about $8 billion) and where there is some question about when it may be able to begin substantial net repayments to the Fund. For Argentina (with about $14 billion of IMF credit outstanding), the issue is more immediate—without an agreement on a new IMF program which effectively rolls over most of the large payments coming due during the next year, Argentina will probably be forced to go into arrears to the IMF and to the World Bank and the IDB. For Turkey, there is already a large volume of IMF credit outstanding, and the amount appears likely to continue to increase for some time and probably quite substantially. Where and when Turkey will get the resources to begin substantial repayments to the IMF remains an interesting question. For Uruguay, IMF credit already outstanding (now about $1.5 billion) is not that large in absolute amount, but if Uruguay became unable to make scheduled repayments to the IMF, this alone would about double the amount of IMF credit that is now formally in arrears.

If Brazil (which already has about $17 billion of IMF credit outstanding) were to go the way of Argentina, there might well be another large chunk of IMF lending that either goes into arrears or needs new programs just to roll over obligations to the IMF. If Brazil does follow this course, large further disbursements to Brazil in the near future will only make the problem of the IMF's finances that much worse.

In the long-run, I doubt that countries like Indonesia, Argentina, Turkey, Uruguay, or Brazil will fail to repay their obligations to the IMF. But there is still a rising risk that an important part of the IMF's resources will be tied up with a few countries that are unable to repay in a timely matter. This would seriously hamper the ability of the IMF to respond to the needs of its other members and to play its proper and intended role in the international monetary and financial system. It would also contradict the letter and spirit of the IMF's Articles of Agreement. Members' use of IMF resources is supposed to be "temporary," and that IMF programs are supposed to contain adequate safeguards to assure that use of the IMF's resources is, in fact, temporary. If these principles are violated on a substantial scale, then the IMF is not fulfilling its important responsibilities, and those primarily responsible for its stewardship, both inside and outside of the institution, are failing in their primary responsibilities.

Sovereign Default and Debt Restructuring

One of the proposals for helping to deal with emerging market financial crises that has recently received much attention is the suggestion of creating a sovereign debt restructuring mechanism (SDRM) through an amendment of the IMF's Articles of Agreement. A SDRM would provide an internationally approved set of procedures for a sovereign debtor in default (or potential default) on its obligations to reach an agreement with its creditors to restructure its obligations in a manner that would plausibly allow it to meet its new obligations while treating its various creditors in a responsible manner. Under such an SDRM, the existing rights of creditors to sue in national courts to seek recovery of their claims would be suppressed (at least for some period) and would be superseded by an agreement between a qualified majority of creditors and the sovereign on a debt restructuring.

Anne Krueger, the First Deputy Managing Director of the IMF, has been at the forefront of those suggesting that a SDRM is needed and desirable. A good deal of work on this issue has now been done by the IMF staff, which is reported on the IMF's website at *www.imf.org.* The issue has been discussed by the IMF's Executive Board. At its meeting on September 28, 2002, the IMF ministerial committee, The International Monetary and Financial Committee, directed that work on this issue

should continue with the objective of examining specific proposals at its meeting next April. The IMFC, however, has not endorsed the establishment of a SDRM. Beyond ministerial endorsement, establishment of a SDRM would require approval and ratification by members representing 85 percent of the voting power of the IMF—including formal ratification of an amendment to the Articles of Agreement by the U.S. Congress

It is essential to understand that present proposals for a SDRM would apply sovereign debt issued by all members of the IMF, but only to debt of sovereigns issued under foreign law. Sovereign debt issue under domestic law (which is the vast majority of sovereign debt, particularly for industrial countries like the United States) would not be covered. Official loans to sovereigns by other governments and by the international financial institutions would be excluded from the SDRM. The SDRM would also not apply to other (nondebt) obligations of the sovereign whether contracted under domestic or foreign law. Also, the SDRM would not apply to private debts or other contractual obligations, whether within a country or across national boundaries, regardless of the legal jurisdiction of the contract. These limitations are vitally important because they clearly imply that there are many important issues in typical emerging market crises that a SDRM does not address at all.

Of course, one might consider a systemic restructuring mechanism (SRM) that would address the restructuring of all of a country's obligations, domestic and foreign, debt and nondebt, and public and private, regardless of questions of legal jurisdiction. Such a monstrosity, however, would be inconsistent with the most basic principle of the present international order—the principle that sovereign nations are responsible for the management of their own internal affairs. When a sovereign and its creditors chose to write their debt contracts subject to the law of another country, it is reasonable for that other country and for the international community to establish some rules for how defaults should be handled. It is quite another thing for the international community to assert the right to intervene in a sovereign's treatment of its domestic debt or into disputes among private contracting parties. This would imply extraordinary authority for the international community to intervene into the economic, financial, and legal affairs of sovereign nations, potentially including the overruling of national laws, court decisions, and even provisions of national constitutions.[7] Most countries would rightly and strenuously object to such intrusions; and the international community would be exceedingly unwise to consider any mechanism that would systematically involve it in such intrusions. (As my colleague on this panel, Professor Tarullo, is better qualified to discuss this particular issue, I will leave further comment to him.)

Arguably, a SDRM limited to the foreign-law debt of sovereigns would improve on present procedures for resolving sovereign defaults. Take the case of Argentina—which involves by far the largest default by an emerging market sovereign on its foreign-law debt. Excluding bonds held by Argentine institutions (where the legal status is somewhat obscure), there the Argentine government has about $50 billion (face value) of foreign-law bonds outstanding, spread over more than 80 separate issues, and at least 5 different legal jurisdictions. Some of the bond issues have collective action clauses which allow a qualified majority of bondholders to agree to a restructuring and impose its terms on all holders of that issue. Many of the bonds, however, follow U.S. legal practice and require that each bondholder preserves the right to pursue legal action for collection unless he individually agrees to a restructuring. Clearly, resolving Argentina's sovereign default on its foreign-law debt will be a legal nightmare that is likely to take many years to conclude.

If it were applicable to Argentina, a SDRM along the lines that has been discussed within the IMF would help to cut through at important part of this legal nightmare.[8] Existing legal requirements would be suppressed, and qualified majorities of the holders of all separate bond issues would be able to agree to restructurings of their particular issues. A qualified majority of the holders of all the bonds would (through means that I do not entirely understand) be able to agree to an overall restructuring. This would still leave difficult problems of actually reaching agreement within and between different groups of bondholders and between bondholders and the sovereign. But individual bondholders and small groups of bondholders

[7] Under the conditionality associated with IMF programs, countries are often required to undertake policies requiring legislation or even constitutional modification. But an IMF program is negotiated with a country's authorities who are free to reject the program and its conditionality if they so choose. A SRM that applied universally to IMF members, regardless of their wishes in individual cases, would represent a much greater infringement of the principal of national sovereignty.

[8] A newly created SDRM probably could not be applied on an ex-post basis to Argentina. But consideration of how a SDRM would work in this case is very useful for consideration of what a SDRM might accomplish in cases where it would apply.

would have much less latitude than at present to disrupt an agreement and/or to stay out of an agreed restructuring in order to pursue their claims independently.

Granted that a SDRM might proved helpful securing more orderly restructurings of sovereign foreign-law bonds when they fall into default, should creating a SDRM be a high order priority for reform of the international financial system? I have been, and I remain, highly skeptical. Whatever might be its advantages or disadvantages in resolving sovereign defaults, there is no credible reason to believe that a SDRM would meaningfully reduce either the likelihood of emerging market financial crises or the severity of such crises when they occur.

Anyone who doubts the validity of this bold assertion should read carefully the literature on the SDRM (especially that recently produced at the IMF) to find the detailed analysis of how a SDRM would have materially reduced the frequency and severity of the many emerging market financial crises that we have seen in the past decade. There is no such analysis. Instead, the sense of urgency for consideration of a SDRM has been built on two concerns: (1) existing legal procedures do not provide an orderly and reliable means for resolving sovereign defaults on their foreign-law bonds; and (2) there has been a lot of highly damaging emerging market financial crises in recent years. But is there any meaningful link between these concerns—a link that is absolutely essential to establish an urgent case for a SDRM. A little reflection on the facts clearly indicates that there is no such link.

Take the present crisis in Argentina. Among the major emerging market financial crises of the past decade, this is the only case where sovereign default on a large volume of foreign-law debt has actually occurred. Undoubtedly Argentina is now undergoing a severe economic and financial crisis. Real GDP is down 15 percent from its year ago level and is down about 25 percent from its peak in 1998—the worst output drop suffered by Argentina in this century and surely one of the worst suffered in all of Latin America. But what has the default of the Argentine sovereign on its foreign-law debt contributed to this catastrophe? And what would a SDRM have done to lessen this damage? To both questions the answer is—practically nothing. Default on Argentine government debt held by Argentine banks has played some role in the collapse of the Argentine banking system, but this debt has effectively been transformed into domestic-law debt. As far as the sovereign's foreign-law debt is concerned, the Argentine government has simply stopped paying both the interest and the principal. Bondholders have complained. A few have filed suits in European courts; but foreign courts have not authorized seizures of Argentine assets. More generally, actions by Argentina's disgruntled foreign bondholders have simply not played any significant role in Argentina's present economic disaster.

Down the road, of course, it is possible that difficulties in restructuring Argentina's foreign-law debt will create problems for the Argentine economy. When might these problems come and how severe might they be? No one can know for sure, but experience and common sense suggest that the problems probably will not come soon and, relative to Argentina's present difficulties, will likely not be that severe. In particular, the case that is cited as exemplary of the problems that can arise in the absence of a SDRM is the case of *Elliot Associates* v. *Peru.* In this case, many years after the Peruvian government had defaulted on some foreign-law bonds, a hold-out creditor was able to secure a court judgment enforcing payment under the original terms of the debt contract. This cost the Peruvian government some money, but it had no significant negative impact on the performance of the Peruvian economy. The example of Elliot Associates may encourage hold-out creditors in the case of Argentina; and this may delay and complicate negotiations over debt restructuring and ultimately cost the Argentine government some money. However, negotiations over debt restructuring will probably drag out for some time in any event, and payments to hold-out creditors are likely to be even further in the future—by which time the Argentine economy will hopefully have enjoyed substantial recovery.

Sovereign defaults on foreign-law debt have also occurred recently for some smaller emerging market economies, notably Ecuador and Ukraine; and Pakistan has recently restructured much of it foreign-law debt. I am not an expert on these cases, but my general impression is that restructuring has proceeded relatively smoothly, despite the absence of a SDRM. A much larger and more complicated sovereign default, such as that of Argentina, might ultimately prove much more difficult to resolve. But, so far, the fears about the extreme difficulties of sovereign debt restructuring in the absence of a SDRM, and especially about the great damage likely to be done to the countries involved, have not proved to be well founded.

Looking to the major emerging market crises of the past decade, other than the present crisis in Argentina, sovereign default on foreign-law debt simply did not

play a significant role.[9] Specifically, in the Mexican crisis of 1995, the main problem was an overvalued exchange rate and difficulties in rolling over the tesobonos (domestic-law debt) and international credit lines to Mexican banks (private debts). In the Argentine crisis of 1995, sovereign default was not a serious risk. In Thailand's crisis of 1997–1998, the problem was an overvalued exchange rate and actual or potential defaults on foreign credits extended to Thai financial institutions and corporations. In Indonesian, the problem was credits extended to Indonesian corporations by both foreign and domestic financial institutions. In Korea, the problem was an over-leveraged domestic corporate sector, weak banks, and international credits to Korean financial institutions. In Russia in 1998, lack of fiscal discipline led ultimately to default on the government's GKO's—domestic-law debt denominated in domestic currency—as well as widespread default by Russian banks on foreign-currency hedge contracts. In Brazil in 1998–1999, doubts arose about fiscal sustainability, but default on the sovereign's (mainly domestic-law) debt was avoided. In Turkey since early 2001, there have been questions about debt sustainability for the government and the banking system; but most of the debt in question is domestic-law and/or private. The growing volume of official debt of Turkey, mainly to the IMF, would not be subject to a SDRM. In Brazil at present, there are worries both about fiscal sustainability and about external payments viability; but most government debt is domestic, and most external debt is private. In Uruguay at present (if this is considered a "major" emerging market financial crisis), there are concerns about the sustainability of the public debt, which is mainly domestic-law debt; as well as with the stability of the domestic banking system which has a large volume of foreign-currency denominated liabilities. Thus, in all of these cases, it is hard to see that if a SDRM had been available it would have done much good; certainly it would not have been a magic bullet that would have avoided a crisis or substantially diminished its severity.

Even if a SDRM would do little good in dealing with potential or actual emerging market financial crises, if it might occasionally do some good, is there reason to oppose it? Might it also do significant harm? There is at least some reason to be concerned with this possibility. Those who are most directly concerned foreign-law debt of emerging market sovereigns—the issuers of such debt, the investors in such debt, and the underwriters and brokers of such debt—generally oppose a SDRM. The issuers fear that their borrowing costs will go up because investor will demand higher rates to compensate for increased risks of losses from defaults under a SDRM. Investors object because they fear that their rights to recover when a sovereign defaults will be compromised and eroded by a SDRM. (Indeed, some are so fearful that they have chosen to embrace the more modest proposal of requiring collective action clauses in all emerging market debt issues—provided that the "nuclear option" of a SDRM is abandoned.) The market makers fear that the volume and profitability of their business will decline under a SDRM. They may well all be right.

The argument on the other side is that market for foreign-law sovereign debt presently benefits from an implicit subsidy that leads to too much issuance of such debt, too much investment in such debt, and too much dealing in such debt. The implicit subsidy comes from the expectation that, if default threatens, the international community will step in with large packages of official support that will, to some meaningful extent, shield both the borrower and the investor from losses to which they otherwise would rightly have been subjected. Indeed, the principal supporters of proposals for a SDRM include particularly officials from those governments that are the major suppliers of the financing in official support packages. Many of these officials believe that there are huge problems of moral hazard arising from large official support packages, and they see a SDRM as a desirable innovation to help cut back on such packages.

On this controversy, I have a relatively neutral position—both sides are wrong. The fears that the market for emerging market sovereign debt will be destroyed by a reasonably structured SDRM are probably exaggerated. Indeed, it is possible that a well-structured and competently implemented SDRM might improve the functioning of the market to the mutual benefit of issuers, investors, and dealers. On the other hand, concerns about substantial moral hazard arising from (properly implemented) international support packages have no analytical or factual founda-

[9] In arguing that a SDRM would probably be of limited practical use, Edwin Truman, my colleague at the IIE, has emphasized that most of the large emerging market financial crises have not involved sovereign default of foreign-law debt as a major issue.

tion.[10] And, as previously discussed, a SDRM would have little practical relevance to most emerging market financial crisis.

What then should be done about a SDRM? For the present, I would recommend that it continue to be studied; but for two reasons, I would oppose its implementation. First, there is the general conservative principle that it is generally unwise to adopt potentially important innovations when a clear need for them has not been demonstrated and when the possible advantages and disadvantages are not well understood. The fact is that a SDRM would have done little to help reduce the likelihood or severity of past emerging market financial crises. There is no reason to believe that a SDRM is urgently needed now.

Second, there is what I refer to as the "Elmer" principle. Elmer was the cat we had when I was a child about 50 years ago. For a feline, Elmer had a particularly affectionate and docile disposition—except when confronting other male cats, when he exhibited extreme hostility and aggression. In dealing with this latter problem, my father wisely advised, "It is usually a mistake to try to referee a cat fight. You are likely to be scratched and bitten; and your intervention is generally not appreciated by the principal participants."

A sovereign default on its foreign-law debt creates a situation analogous to an enormous cat fight—only involving batteries of lawyers in addition to the primary participants. The interests of the debtor conflict with those of creditors as the debtor strives to pay less and creditors seek to collect more. The interests of different creditors conflict as each attempts to maximize his own return. The interests of other claimants on the sovereign resources (including holders of domestic-law debt) also come seriously into play; the more they get, the less is available for holders of the sovereign's foreign-law debt.

At present, the international community stands largely aloof from the fray, leaving it to the contending parties to work things out as best they can.[11] Under a SDRM, the international community would become a referee of the conflict—at least as far as establishing and attempting to enforce some general guidelines concerning the resolution of differences between the sovereign and holders of its foreign-law debt. Rightly or wrongly, the international community is likely to be accused by all parties of failing to treat their interests fairly, and is likely to be called upon by all parties to use its authority to support their particular interests. And even if the international community could somehow determine what a "fair" resolution was, it would probably be unable to enforce it on all relevant parties—perhaps especially on the sovereign in default and on some of the domestic claimants on the sovereign's resources. It seems to me that the masters of the affairs of the international community would want to think long and hard before embarking of such a hazardous and probably thankless venture.

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[10] The assertion that there is a substantial problem of moral hazard arising from large international support packages is often advanced with great vehemence and conviction (for example, in the majority report of the Meltzer Commission), but little evidence or rigorous analysis has been presented to back this assertion. Instead, like a principle of religious faith, proof is supplied primarily by loud and repeated incantation. Those who have analyzed the issue carefully generally conclude that this asserted problem of moral hazard, while not entirely bogus, has been much exaggerated. See, in particular, O. Jeanne and J. Zettelmeyer, "International Bailouts, Moral Hazard, and Conditionality," *Economic Policy,* 33, October 2001, pp. 409–431. I have also examined this issue quite extensively; see Mussa, *et. al.,* "Moderating Fluctuations in Capital Flows to Emerging Market Economies, in P. Kenen and A. Swoboda (eds.), *Reforming the International Monetary and Financial System,* International Monetary Fund: Washington, DC, 2000, pp. 75–142; M. Mussa, "Reforming the International Financial Architecture: Limiting Moral Hazard and Containing Real Hazard" in D. Gruen and L. Gower (eds.) *Capital Blows and the International Financial System,* Australia: McMillan Publishing Group, pp. 216–236; and M. Mussa, "Reflections on Moral Hazard and Private Sector Involvement in the Resolution of Emerging Market Financial Crises," paper presented to a conference at the Bank of England, July 2002.

[11] The IMF's policy of "lending into arrears" does imply modest official sector involvement in the resolution of sovereign defaults on external debt—just as did the earlier IMF policy of not lending into arrears. Under the present policy, the IMF will, in some circumstances, lend to a country that is in default on its obligations to private external creditors—provided that the sovereign is making reasonable efforts to resolve the situation. This policy presumably gives the sovereign a little more leverage versus his creditors than did the earlier policy of not lending into arrears (which tended to give a little more leverage to creditors). The IMF's judgment about what constitutes a reasonable effort, however, is not intended to be used to influence in any detailed way how disputes between sovereigns and their external private creditors are resolved.

PREPARED STATEMENT OF SCOTT A. OTTEMAN

DIRECTOR OF INTERNATIONAL TRADE POLICY
NATIONAL ASSOCIATION OF MANUFACTURERS

OCTOBER 16, 2002

I am Scott Otteman, Director of International Trade Policy at the National Association of Manufacturers (NAM). The NAM is an organization of 14,000 member firms—10,000 of which are small or medium-sized. Our members produce the vast bulk of U.S. manufactured goods and are world leaders in productivity and product quality.

I am pleased to be here this morning to discuss the financial and economic situation in Latin America and to present the NAM's views on how this affects American business, American jobs, and the U.S. economy. We can look at the relationship from three perspectives: (1) trade—the exports and imports of goods and services; (2) investment—the direct participation of United States firms in Latin American economies; and (3) the effect that financial instability in Latin America might have in terms of a spillover to the broader global economy. While the first two aspects are of considerable significance, it is the third aspect that is probably of the greatest concern to the business community.

The United States-Latin American Commercial Relationship

To begin with, Mr. Chairman, I think it is useful to review the size of the United States-Latin American economic relationship. It is an important relationship for the U.S. economy, but it is especially critical for the Latin American countries' economies. For purposes of my testimony, Mr. Chairman, today I am going speak only of the countries in South and Central America. Mexico, while sharing language and cultural heritage with the rest of Latin America, over the past 10 years has been integrating its economy with North America through the North American Free Trade Agreement (NAFTA). As a result, Mexico's economy is increasingly insulated from economic winds that may affect Central and South America.

United States exports to Central and South America last year were almost $60 billion, about 8 percent of United States exports to the world. Imports from the region were $67 billion last year, about 6 percent of our global imports.

Fully 88 percent of our exports to Central and South America are concentrated in manufactured goods, including computers, aircraft, turbines, plastics, and a broad range of machinery and electrical machinery. Petroleum is our largest import from the region, accounting for about one-third of the total. Apparel is our second largest import from Central and South America, followed by a range of manufactured goods, agricultural products, and raw materials. Our imports are changing in the direction of more manufactured goods, as is seen in the fact that our largest imports from Brazil have become commercial jet aircraft and electrical machinery.

United States foreign direct investment in South America, both overall and in manufacturing, is about 6 percent of worldwide United States direct investment. In 2001, the value of United States investments in South America stood at $83 billion, with $36 billion invested in Brazil and $18 billion in Argentina—the two largest South American recipients of United States direct investment.

The Effect of Financial Instability

Argentina's economic and political crisis and its limited spillover effects to its neighbors have immediately affected United States companies in two ways—via a dramatic decline in United States exports to South America and by substantially worsening the conditions for doing business faced by United States firms operating in the region. Among the companies based in the region, clearly the hardest hit are those based in Argentina itself, though there are trade effects that have also impacted the business environment in neighboring countries.

Exports

United States exports to Central and South America so far this year have fallen 16 percent from the same period a year ago. The three largest proportional declines were to Argentina, Uruguay, and Brazil. Table 1, attached to my statement, shows the changes in United States exports to all countries in the region.

United States exports to Argentina have plummeted a stunning 67 percent—dropping from an annual rate of $4.5 billion to $1.5 billion—a $3 billion fall. Exports to Argentina face a triple-whammy: (1) very low demand due to 4 years of recession/depression in that country; (2) a huge competitive disadvantage due to the 70 percent devaluation of the Argentine peso, which makes foreign imports much more expensive than similar domestic goods; and (3) foreign-exchange curbs imposed by Argentine authorities to improve the country's current account balance.

Exports to Uruguay have fallen 53 percent, though because Uruguay is a much smaller market, the dollar decline was only $240 million. United States exports to Brazil have dropped 26 percent, from an annual rate of $16.5 billion to $12.2 billion—a $4.3 billion fall.

As a rough rule of thumb, the Commerce Department estimates each $1 billion of exports supports approximately 12,500 jobs. This implies that the export losses over the last year to Argentina, Brazil, and Uruguay may have impacted possibly over 90,000 American jobs.

The declines in United States exports to Argentina and Brazil are in line with the decline in these countries' overall imports from the world. For example, Argentina's global imports so far this year have fallen 63 percent—meaning they are only about one-third as large as they were last year. Brazil's total imports have fallen about 23 percent.

Investment/In-Country Operations

U.S. investment in the economies of these countries has been sharply affected as well. United States balance of payments data show, in fact, declining investments to South America, concentrated in Argentina and Brazil. Income on United States investments has plummeted. United States foreign direct investments in Argentina have lost $2 billion in the last 9 months.

Logically, those United States businesses with operations in Argentina are the ones that have been most severely impacted by that country's financial crisis. In responding to the crisis, the Argentine government has forced the conversion of dollar-denominated payments to local currency-denominated payments at a one to one ratio, when the real market exchange rate is closer to one to four (so-called "pesification"). This step alone has slashed the anticipated income stream of U.S. subsidiaries invested locally by 75 percent and made severely undermined the value of many of the underlying assets. At the same time, efforts to recoup these losses by seeking higher prices or charging higher rates for services have been in many cases forbidden, putting many companies—foreign and domestic—in an untenable position and causing many local bankruptcies.

Non-payment of contracts is perhaps the biggest fallout from the crisis for those on the ground in Argentina; it has sapped business confidence and resulted in suppliers demanding upfront payment rather than accepting credit. United States firms in Argentina are finding that even peso-denominated debts are often not being paid by bankrupt or near-bankrupt customers.

United States subsidiaries have been undermined further by a series of measures the Argentine government or legislature has taken to attempt to preserve foreign exchange reserves. This includes the institution of an export tax on a nearly across-the-board basis. For companies that are export-focused, as are many United States operations in Argentina, this new tax partially or wholly undermines the renewed competitiveness won at the altar of the devalued peso. Needless to say, this new tax, imposed as a last resort to raise hard currency, comes at a time of tremendous weakness for most firms.

In addition, the crisis has led the government to impose import controls, limiting the expenditure of dollars on critical inputs needed to sustain or augment production. For example, some U.S. agribusiness firms—which otherwise have good prospects for renewed growth because of the devaluation-related potential for increased exports—find their ability to take full advantage to be hampered by a lack of access to key inputs, such as seed, fertilizer, and farm equipment.

Furthermore, even companies with dollar reserves are missing debt payments denominated in dollars because the Ministry of the Economy must grant permission for such transactions.

Add to these costly measures the understandable worker disgruntlement and the heightened kidnapping and security threats faced by business executives and their families as a result of the drop-off of more than half the Argentine population below the poverty line, and you see that United States companies—along with others—face a very challenging business environment in Argentina today.

Intraregional Trade

Argentina's problems have also affected United States companies' operations in neighboring countries, though clearly to a lesser extent than those based in Argentina itself. The impact has occurred primarily because of lost trade due to the collapse of sales to Argentina, which had been a significant portion of sales for many export-focused companies in an increasingly integrated South America.

A broader "contagion" effect—with severe pressure on the domestic currency and the banking system, as foreign and domestic investors rush for the exits—has also

been seen in Uruguay. But in the case of Brazil, our understanding is that most financial experts attribute the recent pressure on the Brazilian currency to uncertainty surrounding the outcome of Brazil's current presidential elections and the new government's possible economic team and policies rather than to fallout from Argentina.

The United Nations' Economic Commission for Latin America and the Caribbean (ECLAC) has done some estimates of the decline in intraregional trade in South America due to Argentina's economic problems. ECLAC says Argentina's imports from its neighbors are expected to tumble from $6.5 billion in 2001 to $2.2 billion this year. Uruguay has been hit the hardest, with its goods exports to Argentina falling 70 percent in the first 4 months of 2002 compared to the same period in 2001. Brazil has also seen its merchandise exports to Argentina slide dramatically. Argentina accounted for 11 percent of Brazil's exports in 2000, but now only account for 4 percent. The 62 percent decline in Brazil's exports to Argentina so far this year is equivalent to an overall decline of 7 percent in Brazil's total exports. United States companies' Brazilian and Uruguayan operations are among the firms suffering from these trends.

Political Impact

Perhaps the longer-term danger for United States business and for the interests of Latin America and the United States in the Western Hemisphere is the emerging perception among the people and politicians of the region that financial crisis and economic stagnation are somehow caused by free-market reforms. Over the past 15 years, newly democratic Latin American governments made tremendous strides in opening their highly regulated, over-protected economies—controlling inflation, attracting foreign investment, privatizing state enterprises, and lowering trade barriers. Until 1997, these reforms yielded substantial though uneven growth. It seemed only a matter of time before the open-market policies known as the "Washington Consensus" would deliver on the promise of broader prosperity across the region. Over the last few years, however, growth has slowed, and recurring financial instability has continued to be a major problem. Increasingly, leading actors on the Latin American political scene are raising questions about the free-market model's ability to provide sustainable economic growth and development.

The collapse of Argentina, whose governments in the 1990's were viewed throughout Latin America as among the most aggressive implementers of open market reforms, threatens to further inflame protectionism and antireform sentiments in the Americas. Attributing Argentina's current predicament to "outside forces" or globalization per se may be a popular way to win votes, but it cannot restore confidence or form the basis for a reactivation program that allows one to actually govern and deliver sustainable results to society.

In our view, any attempt to turn back the clock by returning to policies aimed at substituting inefficient domestic production for competitive imports or rolling back other reforms would be a costly and disastrous mistake. Although some of the reforms of the late 1980's and 1990's could have been carried out more gracefully—perhaps at a different pace, or in a different sequence—the main problem is that the reform process has not advanced deeply enough. Rather than return to the past, Latin America needs to continue opening its economy to trade and investment. The so-called "first generation" reforms I mentioned earlier need to be complemented with "second generation" reforms that promote respect for the rule of law (judicial reform), tax reform, labor market mobility, limits on government spending, educational reform, and sensible regulatory regimes. No amount of populist rhetoric can alter this reality.

An Even Bigger Concern: Brazil's Future Policies

If financial collapse were to spread to Brazil—either because of contagion from Argentina, uncertainty provoked by the new Brazilian government's economic and financial policies, or some combination—the potential negative impact on United States business would be vastly enlarged. Some 400 of the United States *Fortune 500* companies have operations in Brazil, which continues to be South America's most dynamic economy and the eighth largest economy in the world. A Brazilian financial disaster such as Argentina would not only undercut the operations of United States firms invested and trading in Brazil, it could spread investor panic and depress growth prospects throughout Latin America and perhaps the rest of the developing world, similar to what we saw initially with Mexico in 1994 and with Asia in 1997. I want to underscore that, in my opinion, we are far from this scenario, which is one that certainly can and must be avoided.

U.S. policy and the international financial community have important roles to play in avoiding this type of disaster. I will leave it to the financial experts to make

recommendations to the U.S. Government and international financial institutions. However, the experience of NAM member companies as international traders and investors leads us to believe that the most critical role in avoiding such a crisis inevitably falls to the Brazilians themselves. Regardless of who wins the October 27 run-off, the new Brazilian President can do much to allay (or enhance) the uncertainties found in financial and business circles today. Here are a few suggestions:

- Appoint an experienced economic team that understands international finance and recognizes the importance to Brazil's future of deeper and broader integration into the world economy.
- Make clear that the new Brazilian government will honor its international debt and other obligations.
- Reaffirm Brazil's commitment to successfully negotiating a Free Trade Area of the Americas by no later than 2005, as President Cardoso pledged, along with 33 other Western Hemisphere leaders, in 1994.
- Take the lead among Latin American nations in insisting that the FTAA include chapters or provisions that fully protect foreign investors, fully respect and enforce intellectual property rights, expedite shipments through customs, and guarantee transparent, nondiscriminatory competition for government contracts. (Naturally, Brazil should seek to negotiate an FTAA agreement that is strongly in its interest, just as United States officials are doing to promote the achievement of United States interests. But the important thing is that the incoming Brazilian authorities make it plain that, contrary to their campaign rhetoric, they recognize the FTAA is essential for Brazil's future.)

In the cases of Argentina, Uruguay, and Brazil, one of the most important things that must be restored is confidence. Investors, both local and foreign, must become confident that government officials and international institutions can stabilize the situation and ensure the preconditions for resumption of growth. Local residents will not bring their savings back to their countries and foreign investors will not resume investing until they believe their capital will be safe.

Looking to the Future

Once the immediate threat of financial crisis is overcome, there are additional steps that must be taken to achieve the stable, democratic, and prosperous Western Hemisphere that should be the ultimate objective of U.S. foreign policy. In particular, I would call your attention to the need to advance several initiatives that aim to bring about a stronger rules-based system with improved adherence to the rule of law and to practices of good governance.

The most important step would be for Latin American governments, including Brazil as I mentioned earlier, to reiterate their support for the Free Trade Area of the Americas (FTAA) negotiations and urge that the agreement be concluded as quickly as possible. Prior to the United States Congress' approval of Trade Promotion Authority earlier this session, Latin American and Caribbean governments could legitimately question the United States' commitment to completing the FTAA. That is no longer the case, and with the United States prepared to issue its initial FTAA market access offers as early as this December, the ball is now in the Latin Americans' court. A clear signal from governments throughout the region that they want to negotiate seriously and expeditiously would have a strong positive impact on investors, for embracing the FTAA means that governments intend to face the future with a better and more transparent set of rules that will govern not just trade, but also investment and commercial practices. And more than anything else, embracing the FTAA demonstrates that governments intend their countries to be open markets—open internally and open to trade.

In this regard, it is instructive to recall the experience of Mexico in its two economic crises of the early 1980's and the mid-1990's. In the 1982 debt crisis, Mexico nationalized its banking system, curbed imports, and took other steps that scared off domestic and international investors. As a result, Mexico was not able to regain access to international financial markets for 7 years, and it suffered through the so-called "lost decade" of stagnant growth and deepened poverty. But in the 1994 peso crisis, Mexico was constrained by its membership in the General Agreement on Tariffs & Trade (now the WTO) and the NAFTA agreement from adopting similar antimarket, populist measures. After some initial financial miscalculations, Mexico took remedial measures in 1994 and 1995 that were market-sensitive and gave investors confidence in the economy. Though a deep downturn resulted, its length was limited, and a catastrophe was averted. Mexico regained access to international financing in just 7 months.

Today, as we approach NAFTA's tenth anniversary, investors have many fewer fears about Mexico's future. Even though Mexico is suffering a mild economic down-

turn linked to its relative dependence on the soft United States market, investors remain confident because of its NAFTA obligations and because of the economic and political reforms that have been carried out during the NAFTA years. The same can happen in South American countries, where, in many instances, similar levels of confidence are now absent.

Chile's experience is also instructive. Chile is arguably the most open economy in South America. Its economic and trade reforms have led to the most rapid rate of economic growth in the continent and to an extremely high degree of investor confidence. This confidence is one of the reasons that Chile received an astonishing 70 percent of all new United States foreign direct investment directed toward South America last year.

Additionally, the Inter-American Convention Against Corruption should be rigorously implemented by all countries in the Western Hemisphere. The United States has long been a leader in the fight against corruption in world markets, starting with the Foreign Corrupt Practices Act of 1977. I recognize that the scandals of the past year demonstrate that no nation has its hands completely clean when it comes to corporate corruption. But the United States nonetheless has led, and must continue to lead, this fight throughout the hemisphere, because bribery distorts economies and corruption eradicates faith in governments and economic systems. Corruption undermines social values and democracy, and leads to massive diversion of scarce economic resources away from intended purposes. It retards economic growth and discourages foreign investment. Adherence to the convention, and the establishment of transparency measures for government procurement, would do much to help reestablish the confidence that domestic and foreign investors need.

Conclusion

Along with local businesses and companies around the world that do business with South America, United States firms are clearly being impacted by the economic downturn in South America. This includes both United States exports to the region and United States company production and other business operations in South America. As is evident in the available data, as well as in the anecdotal information, the effect is very marked—especially with respect to Argentina.

U.S. businesses and their employees, of course, want to see a restoration of stability and a return to economic growth just as quickly as possible. American firms are good corporate citizens of the countries in which they operate, and are concerned not just for their own operations but also for the conditions facing the people in those countries. The economic catastrophe in Argentina has brought with it a particularly tragic cost in terms of people's lives and their aspirations for the future.

It is our sincere hope that the U.S. Government, the international financial institutions, and other governments in the Western Hemisphere can learn from the lessons of the past and work together to promote policies that not only avoid repeating such tragedies in the future, but also lay the groundwork for broadening prosperity throughout the Americas.

Thank you.

TABLE 1

World Trade Atlas
United States - Total Exports - F.A.S. by Country
January - July
Millions of US Dollars

Rank	Country	2000	2001	2002	% Change 2002/2001
0	-- World --	440,935	441,500	399,670	-9.5
1	-SOUTH/CENTRAL AMERICA-	32,924	35,203	29,578	-16.0
2	Brazil	8,223	9,615	7,137	-25.8
3	Venezuela	3,068	3,372	2,709	-19.7
4	Dominican Republic	2,539	2,670	2,491	-6.7
5	Colombia	2,079	2,180	2,039	-6.5
6	Costa Rica	1,401	1,458	1,742	19.5
7	Chile	1,827	1,937	1,521	-21.5
8	Honduras	1,459	1,460	1,423	-2.6
9	Guatemala	1,041	1,088	1,162	6.8
10	Ecuador	600	820	961	17.1
11	El Salvador	980	1,025	942	-8.1
12	Peru	964	906	925	2.1
13	Argentina	2,636	2,632	852	-67.6
14	Jamaica	765	827	754	-8.8
15	Panama	995	784	737	-6.0
16	Bahamas	611	588	548	-6.9
17	Trinidad & Tobago	613	562	536	-4.6
18	Netherlands Antilles	336	547	423	-22.6
19	Haiti	337	341	329	-3.5
20	Paraguay	235	247	281	13.8
21	Aruba	162	147	249	68.9
22	French Guiana	10	123	247	100.8
23	Nicaragua	221	268	240	-10.7
24	Bermuda	229	243	194	-20.0
25	Barbados	172	166	152	-8.3
26	Cayman Islands	201	160	130	-18.7
27	Uruguay	324	264	124	-53.2
28	Bolivia	148	113	109	-4.1
29	Cuba	6	2	83	4454.0
30	Belize	130	100	76	-23.9
31	Suriname	71	94	74	-21.0
32	Guyana	87	85	70	-17.0
33	St. Lucia	61	53	51	-4.1
34	Antigua & Barbuda	91	61	47	-23.5
35	Virgin Islands (British)	39	48	40	-16.2
36	Grenada	44	33	31	-6.9
37	Turks & Caicos Islands	53	46	29	-37.5
38	St. Kitts & Nevis	35	30	26	-13.2
39	Guadeloupe	60	37	23	-37.2
40	St. Vincent & the Grenadi	19	21	22	6.8
41	Dominica	23	19	21	10.3
42	Anguilla	12	12	12	6.2
43	Martinique	12	15	12	-21.7
44	Montserrat	7	4	4	0.1
45	Falkland Islands	0	0	0	96.1

The NAM uses the World Trade Atlas Trade Information System, produced by Global Trade Information Services, Inc., for access to U.S. trade data generated by the Census Bureau

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